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September 2013

IFRS Practical Matters in Banking

Leases re-exposed:

The impact on banks

On 16 May 2013, the IASB and FASB (collectively, the Boards) issued their revised exposure draft (revised ED or proposal) on leases, with a deadline for comment by 13 September 2013.

The Boards propose putting most leases on lessees' balance sheets.

- The Boards propose requiring lessees to recognise assets (right-of-use assets) and liabilities (for obligations to make lease payments) arising from their involvement in most leases, based initially on the present value of lease payments.
- For a lessee's lease of tangible assets such as land and buildings, the right-of-use assets may be shown separately on the balance sheet or may be presented within the same line item as the corresponding underlying assets as if they were owned (e.g., PP&E).
- This ability to show a lease of tangible assets within PP&E rather than as an intangible asset may influence regulators' views on the regulatory capital treatment. All entities would classify leases as Type A or Type B to determine how to recognise lease-related revenue and expense. Classification would also affect what lessors record on the balance sheet.
- Lessees and lessors would be permitted to make an accounting policy election, to apply a method similar to current operating lease accounting to leases with a maximum term of 12 months or less.
- The proposal requires significantly more disclosures than the current leasing standard.

Overview

The revised ED proposes a new accounting model for leases that would affect both lessees and lessors. It would, therefore, affect banks in accounting for their activities as lessors and lessees and also as users of their customers' financial information. In addition, the proposal could affect their business model as lessors if customers' behaviour is affected by the proposal (e.g. customers could become less inclined to lease).

The Boards' primary objective is to provide greater transparency around leasing transactions. Not all Board members agree that this objective would be met, largely due to the cost and complexity of the proposal. Two of the 14 voting IASB members and three of the seven FASB members voted against issuing the proposal for comment. To address these concerns and to move towards greater consensus, the Boards are devoting significant effort to outreach on this project.

An effective date has not yet been proposed, but we do not expect a final standard to be effective before 2017.

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What is the likely effect on a lessee's balance sheet?

The revised ED would fundamentally change lease accounting for most lessees. Unless the lease term is short[1], the balance sheet would be grossed up to show a right-of-use asset and a lease liability. On initial recognition, the right-of-use asset would reflect the present value of future lease payments plus any initial direct costs. Banks with significant operating lease commitments, for instance for local branches, would experience a large increase in the gross balance sheet. This also would be true for a bank's customers in industries in which operating lease contracts currently play a fundamental role (e.g., airlines, telecommunications, transport, retail and mining).

What is the likely capital impact for a bank as a lessee?

Given that right-of-use assets would be recognised for virtually all leases, including property, the regulatory capital consequences are a key concern for banks and other regulated entities. If the right-of-use assets were treated as intangible assets, then regulators may apply a 100% regulatory capital deduction.

However, under paragraph 55 of the ED, "If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, the lessee shall … present right-of-use assets within the same line item as the corresponding underlying assets would be presented if they were owned…"[2] In addition, in an example accompanying the ED (paragraph IG 63 of IFRS 1), the right-of-use assets are presented within the caption 'property, plant and equipment'.

While we do not yet know how banking regulators will treat the asset for regulatory capital purposes, presentation of the right-of-use asset with other tangible assets may influence their decision.

The effect on assets and capital may also affect other regulatory measures, such as leverage ratios.

What about lease term extension options?

Under the revised ED, 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.

In making an assessment of whether a lessee has a significant economic incentive to extend a lease, the ED would require consideration of contract, asset, entity and market-based factors including:

- Contractual terms and conditions for the optional periods (compared with current market rates)
- Significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- The importance of the underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset and, also, the location of the underlying asset[3]

This means that banks would consider lease extension options when determining the lease terms and calculating the right-of-use assets and lease liabilities. For example, if fit-out costs are significant and are entered into with the expectation of use over a longer period than the non-cancellable lease term, optional periods may need to be included in the lease term. However, on its own, an intention to exercise a lease extension option would not be sufficient to require the inclusion of the optional period.

Assessing whether there is a significant economic incentive would require judgement (especially sensitive given the capital implications). Lessees and lessors would be required to establish processes and policies to help ensure consistent application.

In addition, banks 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. Relevant factors to consider when evaluating whether the lease term has changed include asset, contract and entity-based factors. Market-based factors also would be considered, but would not, in isolation, be determinative when evaluating whether the lease term has changed. However, such market-based changes could be driven by changes in asset, contract and entity-based factors.

What amounts would be included in lease payments?

Under the revised ED, lease payments would include fixed payments and variable payments based on an index or rate such as CPI or LIBOR. In addition, lessees would need to include amounts expected to be payable under residual value guarantees. Termination penalties and purchase option payments would be included if they were due based on the assessment of the lease term. Other variable rents (e.g., based on performance or usage) would be excluded from lease payments and recognised when they are incurred (by a lessee) or earned (by a lessor). Entities also would need to reassess variable payments based on an index or rate at each reporting period.

[1] If, at the commencement date, the contract has a maximum possible term, including extension options, of 12 months or less and does not contain a purchase option, there would be a policy choice not to apply the requirements in the revised ED.

[2] In this case, the split between lease-related assets and liabilities and other assets and liabilities would need to be disclosed in the notes to the financial statements.

[3] Paragraph B5.

What would be the effect on a lessee's profit or loss?

This depends on how the lease is classified.

The revised ED uses a principle for lease classification that is based on the portion of the economic benefits of the underlying asset that are expected to be consumed by the lessee over the lease term. To reduce complexity, the classification requirements would be based on whether the underlying asset is property or non-property, as follows:

- Leases of assets that are not property (e.g., equipment, vehicles) would be classified as **Type A leases** unless one of the following two criteria is met (in which case, they would be classified as Type B leases):
  - The lease term is for an insignificant part of the total economic life of the underlying asset
  - The present value of the lease payments is insignificant relative to the fair value of the underlying asset
- Leases of property (i.e., land, a building or part of a building) would be classified as **Type B leases**, unless one of the following two criteria is met (in which case they would be classified as Type A leases):
  - The lease term is for the major part of the remaining economic life of the underlying asset
  - The present value of the lease payments accounts for substantially all of the fair value of the underlying asset

Under the revised ED, Type A leases generally would result in accelerated expense recognition since the lease liability would be subject to an effective interest rate like a financial liability and the right-of-use asset would be amortised separately (generally on a straight-line basis).

Type B leases, on the other hand, would result in straight-line lease expense. The accretion of the lease liability would be recognised using an effective interest rate, but the right-of-use asset would be amortised at a rate so as to ensure that the total annual cost is constant. For Type B lessees, the proposal would result in a similar expense pattern as under today's operating lease accounting.

While the Boards have provided some examples to help guide the determination of lease classification, there are no bright lines. The Boards expect a relatively small number of leases to meet the exception criteria. However, lessees and lessors of property should pay particular attention when entering into leases of older property as the exception critieria are based on the *remaining* economic life of the underlying asset.

If an operating lease under today's standards would be classified as a Type A lease, the lessee would report a higher EBITDA.

What would be the balance sheet effect for lessors?

This depends on the lease classification, following the same requirements as for lessees.

For Type A leases, the underlying leased asset would be derecognised, and a lease receivable and an asset representing the residual value of the underlying asset at the end of the lease, would be recognised instead. These could either be presented as a single figure in the balance sheet or as two separate figures. In both cases, these items would be separately presented from other types of assets.

For Type B leases, the underlying asset would continue to be recorded in the lessor's balance sheet, like an operating lease today.

What would be the effect on a lessor's profit or loss?

The same principles apply to income recognition by both lessors and lessees (although there would be differences in more complex situations, such as when there are variable lease payments).

Recognition of income for Type A leases would be closer to that for today's finance leases. This may be a significant change for lessors with leases that are today classified as operating leases, but would be classified as Type A under the proposal. For example, rather than recognising both rental income and depreciation expense under an operating lease, lessors would record a one-time profit or loss at commencement of the lease (if the bank had purchased the leased asset for less than the fair value at commencement), followed by interest income throughtout the lease term (similar to today's finance leases). This would tend to be front-loaded, given the use of an effective interest rate on a declining receivable balance, but the overall impact would depend on the asset's residual value since that also would be accreted over the lease term.

Meanwhile, the receivable and the residual asset would each need to be assessed for impairment (the former using IAS 39 *Financial Instruments: Recognition and Measurement*[4] and the latter in accordance with IAS 36).

The treatment of Type B leases would be comparable to an operating lease today.

[4] The IASB is developing new impairment requirements for financial assets, including lease receivables, in an amendment to *IFRS 9 Financial Instruments*.

What are the other challenges in the revised ED?

The revised ED would result in fundamental challenges for banks and their clients that go well beyond just accounting. Some of these are discussed below.

Management judgements and estimates

The revised ED would require banks and their clients to create a detailed inventory of their arrangements and determine how the proposal would affect the balance sheet, as well as the amount, timing and classification of lease-related revenue and expenses. It is important for companies to consider the following issues.

Which arrangements are leases?

Under the revised ED, the definition of a lease (i.e., a contract in which the right to use an asset is conveyed for a period of time, in exchange for consideration) generally would be consistent with current lease accounting. In some instances, however, it can be difficult to identify lease components in contracts that include a significant service element (e.g., IT outsourcing arrangements or power purchase contracts). In these circumstances, significant judgement would be required to identify leases.

In addition, currently, the accounting for operating leases and service contracts is similar. However, under the revised ED, it would be critical to identify arrangements as leases (or that have a lease component) in light of the significantly different accounting proposed for leases compared to that of service contracts.

Does the lease contain any non-lease components?

Until now, many companies may not have focused on separating non-lease components (e.g., services) from their operating leases because the accounting treatment for the lease component is often the same as the treatment for non-lease components.

However, under the revised ED, lessees would separate non-lease components from the lease when observable stand-alone prices for one or more of the components are available. If non-lease components are not separated, 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 to develop processes to identify observable stand-alone prices for the lease and non-lease components.

Unlike lessees, lessors always would be required to separate non-lease components from the lease, because lessors are expected to know the relative stand-alone selling prices for the lease and non-lease components.

Data collection and ongoing data management

The judgements and estimates required to account for leases under the revised ED would demand in-depth knowledge from accounting personnel, as well as treasury, corporate real estate, business operations, legal, IT and tax personnel. Therefore, a cross-functional project team may be required to gather the data needed to identify and initially record the lease, to determine variable payment terms, termination penalties and extension and purchase options, perform the required periodic reassessments of lease payments and discount rate and assess the impact of lease modifications.

Because the Boards would provide entities with the option to apply either a full retrospective approach or a modified retrospective approach to transition to the final standard, entities would need to decide which approach is preferable. The approach selected would determine the extent to which entities would have to gather historical lease data as of the beginning of the earliest comparative period presented or as of the commencement date of the lease, which could be earlier.

Some entities also would need to evaluate their existing lease processes to determine where lease information is maintained and the level of completeness and accuracy of the information. While existing spreadsheets and programs may include some lease information, they are unlikely to have all of the information required to facilitate the calculations and judgements necessary to comply with the revised ED.

For lessors, the ability to assist lessees in their accounting by providing them the required lease data to help them comply with the revised ED could be a differentiating factor in the service they provide.

Financial statements and metrics

For many lessees, the revised ED would result in a gross-up of the balance sheet. This could cause a deterioration in debt ratios and return on assets compared with current accounting. Certain regulatory ratios also may be impacted. Because the timing of expense recognition generally would accelerate and the expense would be re-characterised as interest and amortisation for Type A leases that were previously operating leases, financial metrics such as EBITDA and interest coverage ratios would be affected.

All companies may need to assess the potential impact on their financial statements and metrics, and evaluate how this could affect the way stakeholders view their financial performance. They would likely need to educate internal and external stakeholders. Some companies anticipate the need to communicate key performance indicators to stakeholders under both current lease accounting and accounting under the revised ED during the transition period.

Banks may need to amend criteria and processes used to monitor credit risks to their customers. Some banks may also choose to continue to use their own calculations for leases, instead of the numbers produced under the requirements of the proposal.

In addition, companies need to identify whether compensation and debt arrangements would need to be changed in light of the revised ED, which may not be simple. For instance, companies may want to negotiate with their banks, either to allow for more headroom in the covenants, or to allow for the continued use of current lease accounting in the covenant calculations. Banks should consider how to deal with such requests.

Lease procurement and structuring

Banks and their customers should understand the potential impact of the revised ED and related financial metrics as they negotiate new leases.

Lessors who employ leasing as a primary market strategy should understand how the revised ED may affect their lessee-customers' behaviour. For example, certain lessees may desire a higher proportion of variable rents to minimise the financial statement impact. However, such terms could result in unpredictable revenue for lessors. As a result, lessors may seek to be compensated by increasing lease payments or reducing lease incentives.

Furthermore, because the proposed lease accounting model differs significantly from current accounting, some lessees may reassess whether buying the asset would be more advantageous than leasing.

At a minimum, banks and their customers entering into new leases today should at least be aware of the potential future impact of the revised ED on their financial statements. Whilst they 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 lessees today, lease arrangements are managed through a variety of spreadsheets or software programs that would not be sufficient to handle the proposed accounting requirements going forward. Banks 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. When 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 increase the burden on 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. Banks that are currently designing or upgrading IT financial reporting systems should consider the potential impact of the revised ED as part of their current IT development efforts. This could reduce the risk of costly re-work and re-design later. Banks also should be mindful that, although IT programs can help accumulate data and perform calculations required by the revised ED, they are not a magic solution – no program can make the critical estimates or judgements the revised ED would require.

Lessors' lease receivables would be subject to the IAS 39[4] impairment requirements. For banks, this will mean that the regular impairment routines should also cover lease assets.

Tax considerations

The revised ED 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. Banks would need to determine necessary changes to tax-related processes and controls required to identify and track tax adjustments. The effect of changing tax treatment could also have a significant impact on the decisions of banks and their customers on whether to lease or buy the underlying asset, or the term of the lease. This may occur when lease expenses have another tax treatment compared to depreciation/amortisation of fixed assets, including right-of-use assets.

What should banks do now?

As currently proposed, an accounting change of this magnitude would present a daunting challenge. Understanding how the proposal would affect your bank and your customers is critical. All companies with significant leasing activities should review the revised ED and closely monitor the Boards' re-deliberations. 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.

EY can bring its multidisciplinary team of accounting, tax, systems and IT professionals to your bank to assist in assessing what the latest proposal means to you. In the chart below, we outline issues and steps you should consider related to the revised ED, and indicate how EY may be able to help you from initial assessment through to adoption.

Issues and steps	**How EY may be able to help**
Gain a general understanding of the revised ED	▶ Design and help deliver a training session for bank personnel ▶ Share insights of IASB, FASB and regulator views
Perform a preliminary assessment of the impact of the revised ED on the bank's financial statements	Advise and provide input into: ▶ Identifying all arrangements that would be in scope ▶ Gathering necessary lease information that would be required ▶ Developing a process for managing the significant judgements and estimates that would be necessary ▶ Assessing lease classification, including estimates of the economic life and fair value of the leased asset ▶ Calculating the financial statement impact and effect on key financial ratios
Assess impact of the revised ED on strategic business decisions	Advise and provide input into: ▶ The impact of changes to financial statement performance and related metrics on existing joint venture agreements, financial covenants or compensation arrangements ▶ Lessees' analysis of whether to continue to lease versus buy ▶ Lessors' decision to change the terms of their lease arrangements to meet the demands of customer-lessees in light of the changes to lessee accounting
Benchmark the bank against peers and others in the industry	▶ Provide observations of how others are approaching the revised ED and problems encountered ▶ Advise on the impact of the revised ED on peers, competitors and specific industries
Assess processes for data collection, internal controls, IT systems and, for lessors, credit impairment processes	▶ Advise on leading practices for design of business processes, IT systems and internal controls ▶ Advise on impairment methodologies ▶ Identify criteria to consider in selecting IT packages and advise in the selection process
Assess tax positions relating to the revised ED	▶ Advise on analysing tax positions arising from the revised ED, reducing tax exposure and determining tax effects of lease modifications
Plan for ultimate adoption of the final standard	▶ Advise on project management and planning, including timeline, tasks and resource allocation
Accounting manuals and policies	▶ Read and provide input into accounting manuals and policies selected by management
Communication to stakeholders: analysts, regulators and shareholders	▶ Advise on developing a communication plan ▶ Advise on drafting communications

More information

Related publications

For more technical discussion about the revised ED, refer to the following publications available through EY, www.ey.com/ifrs:

IFRS Developments: Boards issue revised proposal to put most leases on the balance sheet (May 2013, EYG no. AU1601)

Applying IFRS: A closer look at the revised lease accounting proposal (May 2013, EYG no. AU1622)

Applying IFRS: How the lease accounting proposal might affect your company (August 2013, EYG no. AU1746)

EYG No. AU1851