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June 2013

IFRS Practical Matters

Leases re-exposed:

Another attempt at improving lease accounting

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

The IASB and FASB (collectively, the Boards) have issued their revised exposure draft (revised ED or proposal) on leases.

Here's where things stand now:

- The Boards propose requiring lessees to recognise assets and liabilities arising from their involvement in most leases.
- All entities would classify leases to determine how to recognise lease-related revenue and expense. Classification also would affect what lessors record on the balance sheet.
- The lease classification criteria would be 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.
- Comments on the revised ED are due by 13 September 2013.

Overview

The revised ED proposes a new accounting model for leases that would affect both lessees and lessors. The Boards' primary objective is to provide greater transparency around a company's leasing transactions. Not everyone agrees that this objective would be met, largely due to the complexity of the dual lease accounting model being proposed. Two of the IASB's 14 voting 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 expected to devote significant effort to outreach on this project.

Timing of a final standard and effective date are not yet known. However, IASB staff and one FASB member recently suggested a final standard possibly in 2014.

Who would be impacted by the proposals?

The revised ED would fundamentally change lease accounting for most lessees and lessors. Companies that apply operating lease accounting today to their leases of equipment (such as aircraft, manufacturing, telecommunications, transportation, or mining) may experience the greatest financial statement impact because of proposed changes to both their balance sheets and income statements. While lessees who lease land and buildings may not see a significant change to their income statements, their balance sheets would be grossed-up.

Significant effort may be required to gather the necessary lease information and make the judgements and estimates needed upon transition. This is especially true for companies with leases in a variety of locations or those with leases maintained in multiple systems.

What are the challenges of the revised ED?

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

Management judgements and estimates

The revised ED would require companies to create an inventory of and evaluate their present arrangements and determine how the proposal would affect the balance sheet as well as the amount, timing and classification of lease-related revenue and expense to be recognised. It is key for companies to consider the following issues:

Which arrangements are leases?

Under the revised ED, the definition of a lease (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. However, the Boards changed the 'right to use' part of the definition. This would complicate the analysis in situations when both the lessee and lessor have some rights over the underlying asset. Determining which party has the right to control the use of the underlying asset could be subjective.

In addition, currently the accounting for operating leases and service contracts is often 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.

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 today's accounting treatment for the lease component is often the same as the treatment for non-lease components.

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.

How should the lease be classified?

The revised ED sets forth 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:
  - 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:
  - 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 for lessees and an approach similar to today's finance lease accounting for lessors. Type B leases would result in straight-line lease expense for lessees and an approach similar to today's operating lease accounting for lessors.

While the Boards have provided some examples to help guide the determination of lease classification, there are no bright lines. Applying the proposals would not necessarily be straight-forward and could require considerable judgement.

What periods should be included in the lease term?

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. The proposed definition of lease term is similar to current lease accounting. Assessing whether a significant economic incentive exists would continue to require judgement and require lessees and lessors to establish processes and policies to foster consist application.

In addition, companies 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. Reassessment of lease term could be particularly subjective.

What amounts should 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 would be due based on the assessment of the lease term. Variable rents 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). Companies also would need to reassess variable payments based on an index or rate at each reporting period.

For lessors, 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. Fair value estimates may become more important for leases that are accounted for as operating leases under current accounting, but would be considered Type A leases. Under current accounting, the fair values are used primarily to determine lease classification. However, under the revised ED, the fair value of the leased asset at the beginning of the lease term would affect not only lease classification, but also 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 would be required.

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. Therefore, a cross-functional project team may be required to gather the data needed to identify and initially record the lease, to perform the required periodic reassessments of lease payments and discount rate and assess the impact of lease modifications.

Because the Boards would provide companies with the option to apply either a full retrospective approach or a modified retrospective approach to transition to the final standard, companies would need to decide which approach is preferable. The approach selected would determine whether companies 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 companies 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.

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 expense would be re-characterised as interest and amortisation expense for Type A leases, financial metrics such as EBITDA and interest coverage ratios would be affected.

For lessors with leases that are classified as operating leases today but would be classified as Type A leases, 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 front-loaded, 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 lessors 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.

Companies should assess the potential impact on their financial statements and metrics, and evaluate how this could affect the way stakeholders view companies' financial performance. They will 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 final standard during the transition period.

In addition, companies should 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 need to negotiate with their creditors either 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 ongoing burden of maintaining dual ledgers.

Lease procurement and structuring

Companies 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 shorter lease terms or 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. Lessors also may 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 revised ED 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 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. 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 revised ED as part of their current IT development efforts. This could reduce the risk of costly re-work and re-design later. Companies 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.

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. Companies would need to determine necessary changes to tax-related processes and controls required to identify and track tax adjustments.

What should companies do now?

As currently proposed, an accounting change of this magnitude would present a daunting challenge. Understanding how the proposal would affect your company is critical. All companies with significant leasing activities should review the revised ED, consider submitting a comment letter, 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.

Will you simply wait for the standard to be finalised and accept what the Boards propose or will you voice your concerns and provide thoughtful commentary? Now is the time for you to provide your input.

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

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the revised ED	▶ Design and help deliver a training session for company personnel ▶ Share insights of IASB, FASB and regulator views ▶ Provide input into the company's comment letter on the revised ED
Perform a preliminary assessment of the impact of the revised ED on the company'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 company 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	▶ Advise on leading practices for design of business processes, IT systems and internal controls ▶ 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 Ernst & Young, 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)

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EYG no. AU1694

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