

Proposed accounting changes for leases

What you need to know

- ▶ The joint proposal would result in a single lease accounting model for most leases
- ▶ All assets and liabilities arising under lease contracts in scope are recognised in the statement of financial position
- ▶ The proposed model is a fundamental change in lease accounting from current IFRS
- ▶ The proposal will replace:
 - ▶ IAS 17 *Leases*
 - ▶ IFRIC 4 *Determining whether an Arrangement contains a Lease*
 - ▶ SIC 15 *Operating Leases – Incentives*
 - ▶ SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*
- ▶ The comment period ends on 15 December 2010

Highlights

Substantial changes to the accounting for leases were proposed in the Exposure Draft (ED) issued by the FASB and IASB (the Boards) on 17 August 2010 on their joint leases project. The ED proposes a single model that would be applied to most leases that would effectively end off-balance sheet reporting for leases. The proposed model would also require entities to make a number of estimates and periodically reassess those estimates in accounting for leases. As proposed, the standard would affect existing leases at transition and no leases would be grandfathered.

The proposed changes have taken years to develop and they address some of the more frequent criticisms of the current model including:

- ▶ Economically similar lease transactions result in different accounting
- ▶ Material assets and obligations arising from operating leases are not recorded
- ▶ Estimates at inception of a lease are not reassessed

Scope

The proposed model retains much of the existing requirements¹ relative to assessing whether an arrangement is or contains a lease. As a result, arrangements that are considered leases under existing accounting standards would generally be considered leases under the proposed standard. Among other arrangements, the ED excludes from its scope leases of investment property measured at fair value in accordance with IAS 40 *Investment Property*.

How we see it

Although the criteria for determining what is or is not a lease are not changing, that determination for many arrangements would take on increased importance. As the current accounting for operating leases and service contracts is often similar, determining that a service arrangement contains a lease classified as an operating lease generally does not result in significantly different accounting for the arrangement. That would change under the ED, which would require on-balance sheet accounting for all leases.

Lessee accounting

Lessees would be required to record a liability for the present value of the obligation to make lease payments and an asset representing the right to use the leased item for the lease term (the right-of-use asset). The lease asset and liability to be recorded for each lease would be based on the expected payments to be made over the lease term.

¹ IFRIC 4 *Determining whether an Arrangement contains a Lease*.

Lessees would be required to reassess the estimates and judgements used in determining the liability to make lease payments each reporting period and make adjustments to reflect changes in the liability due to changes in facts and circumstances.

Measurement of the expected payments would require estimates and judgments about uncertain future events and conditions including consideration of renewal options and contingent payments to be made over the lease term. These estimates, made at the inception of the lease, would be a significant difference from current accounting requirements.

Subsequent measurement

The right-of-use asset is amortised over the lease term or useful life of the underlying asset if shorter. A lessee may revalue a right-of-use asset at its fair value in accordance with IAS 16 *Property, Plant and Equipment*. In addition, the right-of-use asset would be subject to IAS 36 *Impairment of Assets*. Interest expense on the liability to make lease payments would be recognised using the effective interest method and lease payments would reduce the liability. For many leases, the total expense recognised (i.e., the sum of amortisation and interest expense) would be higher in earlier periods of the lease and lower in later periods of the lease.

Lessees would be required to reassess the estimates and judgements used in determining the liability to make lease payments each reporting period and make adjustments to reflect changes in the liability due to changes in facts and circumstances.

How we see it

Entities would not be required to perform a detailed analysis of all lease arrangements each reporting period. However, processes would need to be established to identify changes in facts and circumstances that may affect the estimates and judgements used to determine lease obligations.

Transition

Lessees would need to recognise a liability to make lease payments and a right-of-use asset for outstanding leases at the date of initial application of the proposed standard using a simplified retrospective approach. The date of initial application is the beginning of the first comparative period presented in the first financial statements in which the entity applies the new standard.

Lessor accounting

The ED proposes that lessors apply a right-of-use model using one of two approaches. For each lease, lessors would apply either the performance obligation approach or the derecognition approach depending on their exposure to risks or benefits associated with the underlying asset. Under both approaches lessors would record an asset on the balance sheet representing their right to receive lease payments from the lessee. The lease receivable would be measured at the present value of lease payments expected to be received over the lease term, discounted using the rate the lessor is charging the lessee. A lessor would use the performance obligation approach to account for leases when it has retained exposure to significant risks or benefits associated with the underlying asset. The derecognition approach would be used when the lessor has not retained significant risks of benefits associated with the underlying asset.

How we see it

The determination of whether the lessor retains significant risks or benefits associated with an underlying asset and hence the lessor accounting approach to apply is critical.

Performance obligation approach

Under the performance obligation approach, the underlying leased asset is considered to remain the lessor's economic resource, and the lessor is committed to allow the lessee to use the underlying leased asset during the term of the lease. The lessor would retain the leased asset on its balance sheet and would record a lease liability (performance obligation) for its obligation to permit the lessee to use the leased asset. The lease liability would initially equal the lease receivable (less any initial direct costs incurred by the lessor), and the lessor would recognise revenue as the lease liability is satisfied over the term of the lease. Revenue would be recognised by the lessor as the lease liability is reduced in a systematic and rational manner based on the pattern of use of the underlying asset by the lessee (e.g., over time, based on hours of use). A lessor

would not recognise any revenue at the commencement of the lease (i.e., upon delivery of the leased asset) under this approach. Under the performance obligation approach, lessors generally would recognise lease revenue on a straight-line basis, similar to the accounting for operating leases under the current model. Interest income on the lease receivable would be recognised over the lease term using the effective interest method. Lessors would continue to depreciate the leased asset, and the asset would be subject to impairment.

Derecognition approach

Under the derecognition approach, economic benefits associated with the underlying leased asset are considered to transfer to the lessee at the commencement of the lease. The lessor would derecognise a portion of the carrying amount of the leased asset that represents the lessee's right to use the underlying asset during the term of the lease. The remaining portion of the carrying amount of the underlying asset would be allocated to a residual asset. The allocation of the carrying amount between the derecognised amount and the residual asset would be determined on a relative fair value basis at the inception of the lease. The residual asset would not be subsequently remeasured except for impairment or when reassessment of the right-to-use asset results in a change to the residual asset. The derecognition approach could result in the lessor recognising some measure of profit (or loss) as of the start of the lease. Interest income on the lease receivable would be recognised over the lease term using the effective interest method.

Transition

Lessors would need to recognise lease receivables for all outstanding leases as of the date of initial application using a simplified retrospective approach. The lease receivable would be measured at the present value of the remaining lease payments, discounted using the rate charged to the lessee at the inception of the lease, subject to any adjustments to reflect impairment.

For leases under the performance obligation approach, lessors would recognise a lease liability and reinstate any previously derecognised underlying assets. The lessor's lease liability would be measured on the same basis as the receivable, at the date of initial application, and previously derecognised assets would be measured at depreciated cost, adjusted for any impairment and revaluation.

For leases under the derecognition approach, the lessor would recognise the residual asset at fair value, determined at the date of initial application.

Other proposed changes

Sale-leasebacks

Sale-leaseback transactions would no longer provide off-balance sheet financing as all leases would be recorded on balance sheet under the proposed model. In addition, the ED establishes criteria that must be met in order for the parties in a sale and leaseback transaction to apply sale-leaseback accounting (i.e., separately account for both the sale/purchase of the asset and the lease). To qualify for sale-leaseback accounting under the proposed model, the underlying asset must be deemed to have been sold based on an assessment that at the end of the contract, both control of the asset and all but a trivial amount of the risks and benefits associated with the asset have been transferred to the buyer-lessor.

How we see it

A transaction that does not meet the criteria to apply sale-leaseback accounting would be accounted for as a financing transaction by both the seller-lessee and the buyer-lessor. The application guidance in the ED sets out conditions, which do not exist in current IFRS standards, that would normally preclude recording the transferred asset as a purchase or sale. This may make it more difficult for transactions to qualify as sale-leasebacks.

Subleases

In a sublease arrangement one party (the intermediate lessor) acts as both the lessor and lessee of the same asset. That is, one party obtains the right to use the underlying asset under the head lease, and it acts as the lessor in the sublease whereby it conveys the right to use the underlying asset to a different party for the same or a shorter term. The ED does not provide different measurement requirements for the assets and liabilities that arise in a sublease. The lessee accounting model would be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model would be applied to the assets and liabilities that arise in the sublease.

Looking ahead

The ED does not specify an effective date. Instead, the effective date will be considered as part of another project for all major joint projects under way. The Boards have requested that all comments on the ED be received by 15 December 2010. The Boards currently plan to issue a final standard on leases in 2011. The proposed model represents a significant change from current practice, and determining the effects of these changes on an entity that leases assets may involve a considerable undertaking. We encourage companies to analyse the proposed model and the effect it may have on them. In addition, we encourage companies to submit comment letters to the Boards expressing their views on the proposed model and any concerns identified or recommendations developed in assessing the proposed model and its effect on their business. We will be providing a more in-depth publication in September 2010 to assist entities in better understanding the proposed model.

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