

IFRS news

Emerging issues and practical guidance*

Supplement – May 2009

The future of lease accounting

This supplement follows on from the article in last month's *IFRS news* on the lease accounting discussion paper. Marian Lovelace looks in more detail at the proposals announced in March and their implications for businesses.

The basic lease accounting model under IFRS has not changed since the adoption of IAS 17, 'Leases', in 1982. It has been the subject of significant criticism from some quarters for almost as long.

Concerns regarding the off-balance-sheet nature of operating leases, the different treatment of similar transactions and the 'all or nothing' approach to lease accounting led many to criticise the model. This culminated in the 1999/2000 G4+1 white paper, 'Leases: implementation of a new approach'. It proposed a 'property right' perspective, where all leases are recognised on balance sheet, not just finance leases.

A joint FASB/IASB project to address lease accounting was added to the Boards' agendas in 2006. It built on the work contained in the G4+1 report and resulted in the discussion paper, 'Leases: preliminary views', issued in March 2009.

Scope

The DP focuses on lease arrangements within the scope of IAS 17 and FAS 13, 'Accounting for leases'. This includes arrangements that are leases in form but are acquisitions of the leased assets in substance.

IAS 17 applies to arrangements that convey the right to use an asset. FAS 13 applies to arrangements that convey the right to use property, plant and equipment. The scope of IAS 17 is broader than that of FAS 13, because it includes leases of some intangible assets. Property that meets the definition of investment property is within the scope of IAS 40 rather than IAS 17. Under US GAAP, SFAS 13 applies to all leases of investment property. The differences in scope between IAS 17 and FAS 13 are expected to be reconciled before the Boards release a final standard.

The DP also incorporates leases contained within other arrangements (for example, service or supply contracts), as determined by IFRIC 4, 'Determining whether an arrangement contains a lease', and EITF 01-8, 'Determining whether an arrangement contains a lease'. Under the proposal, the leases embedded in these arrangements would be recorded on the lessee's balance sheet at an amount that contemplates expected contingent rentals as well as non-contingent rent payments. Determining the 'rents' in these arrangements can be difficult, as it entails allocating consideration between the service or supply portion and the embedded lease.

At a glance

The proposals:

- Eliminate operating lease accounting.
- Result in all leases, including those in effect when the new standard is issued, giving rise to assets and liabilities for the lessee, similar to capital leases today.
- Require lessees to reassess the lease term, contingent rentals, residual value guarantees and the corresponding lease obligation at each reporting date.
- Are expected to have the greatest impact on lessees of significant amounts of 'big-ticket' items, such as real estate, aircraft and ships. However, they would affect virtually every company, including those that lease cars, computer equipment, copiers, office furniture and telecommunications equipment.

A final standard is expected in 2011. Companies should understand the potential impact now, given the long-term nature of some leases.

PwC insight

The embedded leases within these arrangements are usually accounted for as operating leases under current guidance because the rents to be paid are contingent. Many entities have not previously had to determine the portion of the total contract consideration to allocate to 'minimum lease payments'.

The DP is silent on whether to exclude short-term leases and leases of non-core assets from the scope of the new standard. Board members commented during discussions that many short-term leases and leases of non-core assets may give rise to material assets and liabilities and, therefore, may fail to meet the needs of users.

PwC insight

IAS 17 and FAS 13 include scope exclusions. For example, leases to explore for or use natural resources are excluded from the scope of both standards. The Boards will decide whether to incorporate existing scope exemptions into the new standard before publishing an exposure draft.

The proposed lease standard will apply only to material items. However, the DP does not address high-volume, 'low-value' leases. For example, the lease of one computer may not be material, but the lease of 10,000 computers may be material in the aggregate.

Right-of-use approach

The right-of-use approach that the DP takes requires the lessee to recognise an asset for its right to use the leased item for the lease term (the right-of-use asset) and a corresponding liability for its obligation to pay rentals. This approach applies the same accounting to all lease contracts, so lessees would account for all leases in a manner similar to that used for capital leases today. The current operating lease classification would be eliminated.

The Boards believe the right-of-use approach for lessee accounting is the most consistent with the Conceptual Framework and increases the transparency of lease accounting. Leases are commonly viewed as a form of financing; the obligations recognised on the balance sheet under the right-of-use approach would be consistent with how businesses reflect other financing arrangements.

PwC insight

The proposed model may result in changes in the way companies write leases in the future and may change 'lease versus buy' decisions. The long-term nature of many leases and the Boards' desire for comparability mean that it is unlikely that existing leases will be 'grandfathered'.

Management should consider the implications of these potential changes when long-term leases and contracts are negotiated, even if these arrangements are executed prior to the effective date of the new standard.

Initial measurement

The DP proposes that lessees initially measure the right to use the asset at cost. 'Cost' is defined as the present value of the lease payments discounted using the lessee's incremental borrowing rate. The Boards consider the incremental borrowing rate the simplest approach, as measuring the asset and liability at fair value, or using other rates, can be more difficult for the lessee.

Lease term

Optional periods under existing standards are considered part of the lease term if the lessee concludes at lease inception that it is 'reasonably certain' (IAS 17) or 'reasonably assured' (FAS 13) that the lessee will exercise the right to renew the lease for the optional periods. The DP proposes a 'most likely lease term' approach.

PwC insight

This change may lengthen the accounting lease term beyond that determined under existing standards, as options to renew or extend the term would not have to meet the 'reasonably assured' or 'reasonably certain' threshold currently required before they can be included.

The proposal provides guidance on factors to consider when determining the lease term, such as all contractual and non-contractual financial factors and non-financial business factors. The lessee's intentions and past practice would not be considered in determining the lease term.

Purchase options

Purchase options give the lessee the right to purchase the leased item on or after a specified date. The DP proposes the accounting for purchase options to be similar to the accounting for options to extend a lease. In particular:

- Purchase options are not recognised as separate assets.
- The lessee considers all contractual and non-contractual financial factors, as well as non-financial business factors, when deciding the most likely outcome.
- The obligation to pay rentals includes the exercise price of the option if the most likely outcome is that the option to purchase is exercised.

Contingent rentals

Current practice generally recognises contingent rentals as expenses in the period incurred. The DP proposes a model to reflect the obligation to pay contingent rentals in the initial measurement of the obligation.

PwC insight

The DP proposes that the asset and liability recognised should reflect contingent rental payments. However, some Board members believe the recognition of contingent rent should depend on the nature of the contingency. That is, if the nature of the contingency is dependent on an index, the contingency should be reflected in the asset and liability recognised. If the nature of the contingency is dependent on usage or performance (for example, sales volume), the obligation should exclude the contingent element.

Residual value guarantees

The maximum amount payable under a residual value guarantee is included in the minimum lease payments for purposes of determining the lease classification under existing guidance. A payment under a residual value guarantee is not accrued before payment becomes probable for an operating lease.

The DP proposes that the lessee's obligation to pay rentals should include payments to be made under a residual value guarantee; the Boards tentatively decided that the measurement of residual value guarantees should be consistent with the decisions made on contingent rentals.

Subsequent measurement

The Boards agreed on an amortised cost-based approach to determining the subsequent measurement of the right-of-use asset and of the obligation to pay rentals; they believe it will be the simplest method for preparers to apply.

Changes in estimates and remeasurements

The Boards considered how to deal with subsequent changes in (1) the lease term, including changes in the likelihood of the exercise of a purchase option, and (2) the estimated payments to be made for contingent rentals and residual value guarantees. The DP proposes that lessees would be required to reassess these estimates each reporting period, including consideration of new facts or circumstances, and reflect those changes in the measurement of the lease obligation.

PwC insight

The proposal to reassess these estimates at each reporting date requires significant incremental effort compared to the current model.

The DP proposes a 'catch-up' approach to reflecting changes in estimates in the lessee's obligation to pay rentals. The carrying amount of the obligation is adjusted to the present value of the revised estimated cash flows, consistent with the conclusions of the Boards on measurement of certain other financial liabilities.

The following table summarises the different IASB and FASB views set forth in the DP for changes in certain estimates after lease inception.

Change in estimate	IASB view	FASB view
Lease term (options to extend and purchase options)	Update the obligation using the catch-up approach, with a corresponding adjustment made to the right-of-use asset	
Cash flows (contingent rentals and residual value guarantees)	Update the obligation using the catch-up approach, with a corresponding adjustment made to the right-of-use asset	Update the obligation using the catch-up approach, with the adjustment taken to earnings
Discount rate	Remeasure the obligation using a discount rate equal to the current incremental borrowing rate (perhaps only if there is a change in the estimated cash flows)	Always use the original incremental borrowing rate as the discount rate

Presentation

The right-of-use asset should be presented in the statement of financial position on the basis of the nature of the leased item, but should be presented separately from owned assets. The Boards differ in their views about the presentation of the obligation to pay rentals. The FASB suggests that the liability be presented separately from other financial liabilities; the IASB does not agree.

The presentation of the right-of-use asset within the statement of financial position would most likely drive the related income statement presentation. The reduction to the carrying value of a right-of-use asset presented in property, plant and equipment would be presented as depreciation in the income statement. The reduction related to an intangible asset would be presented as amortisation expense.

The DP discusses possible approaches but does not provide a preliminary view on other income statement and cash flow presentation matters.

PwC insight

The right-of-use model would significantly change financial statement presentation and impact financial metrics, including many metrics used in debt covenants and compensation arrangements. For example, compared to a lease classified as an operating lease under current accounting:

- Balance sheets will include both the right-of-use asset and the lease obligation.
- The expense recognition pattern will change. Expense will be higher than straight-line expense during the early part of the lease term and lower during the latter part of the lease term. The asset will typically be amortised using the straight-line method, but the obligation will be accounted for using an effective yield model. As with any amortising loan, the interest expense will be higher during the early part of the lease term.
- EBITDA is likely to increase, as rent expense will be replaced with interest and amortisation expense, which are below-the-line charges.

Other lessee issues

The Boards have not yet discussed a number of issues in sufficient detail to form a preliminary view. The following are not addressed in the DP:

- Timing of initial recognition.
- Sale and leaseback transactions.
- Treatment of initial direct costs.
- Leases that include service arrangements.
- Disclosure.

Lessor accounting

PwC insight

The Boards have not yet reached preliminary views on these issues, but respondents may wish to comment on them in their response letters. For example, the Boards are considering treating all sale-and-leaseback transactions as either financings, sales or a hybrid of the financing and sales approach. This would have a significant impact on entities that utilise sale-and-leaseback transactions as a means of off-balance-sheet financing, or frequently enter into such transactions. The DP does not touch on all lessee accounting issues. Among those not mentioned are (1) accounting for lease incentives, (2) accounting for lease modifications, and (3) accounting for acquisitions of leased property during the lease term at an amount not contemplated in the recognised obligation.

The Boards have tentatively decided to defer consideration of lessor accounting for the purposes of this DP. Among the reasons given by the Boards for doing so are (1) lessor accounting issues are being addressed in numerous ongoing IASB/FASB projects, such as de-recognition and revenue recognition, and (2) consideration of lessor accounting at the same time as lessee accounting would delay the release of a new standard for lessees, which affects a larger population.

The DP does include a high-level overview of potential lessor considerations without expressing any preliminary views on lessor accounting. However, it describes two methods in which a right-of-use approach could be applied to lessors:

- The lessor would be considered to have transferred all or a portion of the leased item for the right to receive payments over the lease term. The lessor retains the right to the leased asset at the end of the lease term. The lessor derecognises the leased item in its balance sheet and recognises a receivable and a residual value asset.
- The leased item continues to be treated as an economic resource of the lessor. The lessor grants the lessee the right to use its economic resource. The asset remains in the lessor's statement of financial position. The lessor also recognises a lease receivable and corresponding performance obligation.

The DP also considers three ways of addressing subleases:

- Provide additional guidance on how to apply the existing lessor accounting standards to subleases.
- Exclude the head lease from the scope of the new standard.
- Develop a lessor right-of-use model for subleases only.

Timing

Comments are due on the 29 questions in the DP by 17 July 2009. The Boards expect to release an exposure draft in 2010 and a final standard in 2011.

PwC insight

Companies should consider the implications of the DP on their businesses and consider submitting a response letter because of the significant and pervasive nature of the changes proposed.

