

Leases project preliminary views

Overview

On 19 March 2009, the FASB and IASB (collectively, the Boards) issued a Discussion Paper entitled, *Leases: Preliminary Views* (the DP) relating to their ongoing joint project on leases. The objective of the Boards' joint project on leases is to develop a common lease accounting standard to ensure that the assets and liabilities arising from lease contracts are recognised in the statement of financial position. The Boards propose that lease accounting should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position.

The Boards' project on leasing is expected to significantly change how lessees account for leases, particularly leases that are currently classified as operating leases. As such, it is important for companies to understand the Boards' preliminary views in order to proactively assess how the proposed model could affect them. The DP addresses the following areas:

- ▶ The perceived problems with the existing lessee accounting models under both US GAAP and IFRS
- ▶ An explanation of the rationale for requiring lessees to recognise right-of-use assets and lease obligations for all leases
- ▶ The initial and subsequent measurement of right-of-use assets and lease obligations
- ▶ Accounting for changes in assumptions regarding lease obligations in subsequent periods
- ▶ The presentation of leases in the financial statements
- ▶ The effect of the proposed model on current practice
- ▶ A high-level discussion of lessor and sublessor accounting issues

While the joint project originally was expected to address both lessor and lessee accounting, the Boards tentatively decided to defer the development of a new accounting model for lessors and to concentrate instead on developing a new accounting model for lessees. The board's reasons for the decision to pursue lessee accounting by itself is predicated on two key considerations:

- 1) That the major criticism of lease accounting is that lessees do not reflect all lease obligations on their balance sheet, although they obtain a right to use the leased item; and



2) Concerns that lessor accounting would not only significantly delay the project, but would be difficult to resolve without reconciling any conclusions with the revenue recognition project currently underway or differences in accounting for investment property between US GAAP and IFRS. However, the DP does include a brief discussion of lessor accounting issues that would need to be considered were the project expanded to address lessor accounting. The Boards are expected to mount a fresh challenge to the tentative decision to pursue only lessee accounting after the issuance of the DP.

We encourage companies to review the DP and provide feedback to the Boards that will assist them in the development of a high quality accounting standard. The deadline for comments is 17 July 2009.

Summary of preliminary views

The proposed model would apply to all lease arrangements within the scope of the existing lease accounting literature. Under the proposed model, lessees would record an asset representing their right to use the leased asset during the term of the lease and a liability for their obligation to make rental payments under the lease.

The right-of-use asset and lease obligation initially would be measured and recorded at the present value of the expected lease payments to be made over the term of the lease. The lease term would represent the most likely term of the lease based on an assessment of all contractual, non-contractual and business factors and would consider the likelihood of exercise of renewal, termination and purchase options. The expected lease payments would include

rental payments required under the lease, as well as the lessee's best estimate of payments expected to be made during the lease term related to contingent rentals and residual value guarantees. The present value of the expected lease payments would be calculated by discounting the expected lease payments using the lessee's incremental borrowing rate.

The right-of-use asset would be amortised over the shorter of the lease term or the economic life of the leased asset. The lease payments would be allocated between a reduction in the outstanding liability and interest expense under an effective yield method.

The lease obligation would be remeasured in subsequent reporting periods if there is a change in the assumptions about the lease term and/or the expected lease payments. An assessment would be performed at each reporting date to determine whether such a change has occurred (e.g., changes in the assumptions about the lease term or estimated contingent rental payments). If a change in assumptions were to occur, a lessee would remeasure the lease obligation at the present value of expected lease payments using the revised assumptions. The DP describes various approaches to recognising the effect of remeasuring lease obligations (i.e., immediately recognise a gain or loss, adjust the carrying amount of the right-of-use asset, or a combination of immediate recognition and adjustment of asset carrying amount) and presents the Boards' preliminary views on these approaches.

While the Boards agree on the general model discussed above, they have differing preliminary views on the several aspects of the model, including:



- ▶ **The measurement of contingent rental payments and residual value guarantees** – the IASB supported a probability-weighted approach to include contingent rentals and residual value guarantees in the lease measurement, whereas the FASB preferred an approach focusing on the most likely outcome.
- ▶ **The discount rate used to remeasure the lease obligation if assumptions change in subsequent periods** – the IASB supported an approach that would require reassessment of the incremental borrowing rate while the FASB's preferred approach does not.
- ▶ **The recognition of changes in the lease obligation as a result of changes in assumptions in subsequent periods** – the IASB supported an approach that would adjust the carrying value of right-of-use asset for all changes, whereas the FASB preferred an approach that would immediately recognise a gain or loss for certain changes and adjust the carrying value of right-of-use asset for others.
- ▶ **The presentation of right-of-use assets and lease obligations in the financial statements** – the FASB's approach would require separate presentation of lease obligations from other liabilities, whereas the IASB's approach would not. Furthermore, some FASB members support a view that assets obtained in leases that are, in substance, purchases should be presented separately from other right-of-use assets.

Changes from existing IFRS

The proposed model represents a fundamental change from current practice in accounting for lease arrangements as it effectively eliminates operating leases for lessees. For example, under the proposed model, a lessee that leases one floor in an office building under a five-year lease with no renewal option, would record, on its balance sheet, an asset for the right to use the space for the term of the lease and a liability for the obligation to pay rentals.

The changes resulting from the proposed model could significantly affect a company's reported financial position because assets and obligations related to lease arrangements currently classified as operating leases would no longer be off-balance sheet. This proposed change could have a significant effect on metrics that are used to evaluate a company's financial performance (e.g., debt-to-equity ratios, return on assets, etc.) and compliance with loan covenants.

Although the proposed model is significantly different from current practice for operating leases, the Boards' preliminary views represent a practical response to many of the criticisms of current lessee accounting. The Boards have tentatively rejected certain proposed approaches to lease accounting in an effort to prevent unnecessary complexity for preparers and users of financial statements. For example, the proposed model measures lease obligations and right-of-use assets at the present value of expected lease payments as opposed to using more complicated fair value measures.

Also, the Boards tentatively decided to adopt a single asset and liability approach, as opposed to a more complex components approach which would require separate measurement and accounting for various aspects of lease arrangements, such as renewal or purchase options and residual value guarantees. However, the proposed approach will require lessees to apply judgment and make estimates about the lease term, contingent rentals and residual value guarantees that could be challenging in some circumstances.

Next steps

As the Boards are still developing the proposed accounting model, the DP does not include converged preliminary views on all aspects of the model. In addition, the DP does not include preliminary views on a number of significant topics that will ultimately need to be addressed in an exposure draft of the proposed standard.

Certain of these topics include:

- ▶ Whether a final standard will include a new model for lessor or sublessor accounting
- ▶ Convergence of the current scope differences between US GAAP and IFRS lease accounting standards
- ▶ The timing of initial recognition of assets and liabilities arising in a lease contract when the lease inception date differs from the lease commencement date
- ▶ The accounting for sale-leaseback transactions, including sale-leaseback transactions involving real estate
- ▶ The accounting for initial direct costs incurred to negotiate a lease (e.g., commissions and legal fees)
- ▶ Whether additional guidance is needed on separating payments for services from other lease payments in lease contracts that include service arrangements
- ▶ Disclosures about leases in the financial statements
- ▶ Effective date and transition guidance
- ▶ Required changes to other existing US GAAP and IFRS standards

The Boards intend to deliberate the topics for which they have divergent views and the topics yet to be addressed during the comment period for the Discussion Paper. The Boards will also review comments received on the DP, discuss the method of transition and effective date and modify or confirm their preliminary views. The Boards are then expected to develop and expose for public comment an exposure draft of a new standard on accounting for leases, which the Boards currently plan to issue in the second quarter of 2010. The IASB expects to issue a final standard in 2011.

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