IFRS industry insights

The Leases Project – An update for the financial services industry

The Boards tentatively decided to confirm the right-of-use model for lessees except for short-term leases that have a maximum possible lease term of 12 months or less.

In August 2010, the IASB and FASB (the "Boards") took a major step towards overhauling the existing lease accounting rules by issuing a set of proposals in the form of an exposure draft (ED). The proposals would significantly affect the accounting for lease contracts for both lessees and lessors across all industries. Since issuing the ED, the Boards have conducted extensive outreach. The comment period, which ended on 15 December 2010, garnered over 750 responses, and resulted in roundtable sessions that included participants from all constituencies, including preparers, users and auditors from a wide cross section of industries. Many respondents indicated that the proposals would significantly affect their key performance indicators, existing debt covenants and ability to obtain financing. As a result, these respondents believe that there would be a desire for short-term leases and an overall decrease in the leasing of assets.

Respondents from the financial services industry, who commonly act as lessees and lessors, expressed concern about a number of proposals in the ED, including the recognition of assets and liabilities, expense recognition pattern for lessees, contracts containing lease and service components, variable lease payments and lease term. The Boards recently discussed these topics and made some tentative decisions which differ from the proposals in the ED. Several financial services industry respondents also expressed concern over the proposals in the ED regarding lessor accounting, but the Boards have only recently commenced redeliberation on lessor accounting. We will update you on tentative decisions reached relating to lessor accounting in future IFRS Industry Insights.

Recognition of assets and liabilities

The ED introduced the right-of-use model for lessee accounting. Under this proposed model, a lessee would recognise an asset that represents the lessee's right to use the leased asset for the lease term and a liability that represents its obligation to make lease payments.

Several financial services industry respondents expressed concern about the potential effect that recognising a right-of-use asset would have on regulatory capital requirements for regulated financial institutions. These respondents indicated that regulators may treat the right-of-use asset as an intangible asset (resulting in their deduction from regulatory capital). This would increase costs to financial institutions. Many respondents believe that the right-of-use asset should be presented according to the nature of the underlying leased item; that is, included within property, plant and equipment or investment properties.

The Boards tentatively decided to confirm the right-of-use model for lessees except for short-term leases that have a maximum possible lease term of 12 months or less. Therefore, for all leases other than short-term leases, a lessee would recognise a right-of-use asset representing its right to use an asset during the lease term and a liability to make lease payments.

The tentative decision would require financial institutions to recognise assets and liabilities on the statement of financial position for all leases other than short-term leases. It is unclear how regulators will treat the right-of-use asset. Additionally, many financial institutions have leasing subsidiaries that lease assets to customers on the basis of the "off-balance sheet" treatment that the current accounting rules allow for operating leases. Financial institutions that are lessors will need to closely analyse the terms of existing and new lease contracts and consider the potential effect that the proposals will have on their current business model.

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Expense recognition pattern for lessees

The ED proposed that rental expense would be replaced with amortisation expense and interest expense, with total expense recognised earlier in the lease term. Financial services industry respondents expressed concern with the proposed pattern of profit or loss recognition arising from the front loading of interest expense described in the ED, as respondents noted that this may impact key performance indicators (e.g., leverage ratio) used by some regulators and financial statement users. Many respondents also believe that the ED would result in:

- further divergence from the cash payments made in lease contracts and economic benefits afforded through lease transactions; and
- distortion of performance metrics of a lease contract given that lease assets and liabilities are not linked.

In April 2011, the Boards tentatively decided that there should be two types of leases for lessees and lessors – finance and other-than-finance leases – and the determination of whether a lease is a finance or other-than-finance lease would be based on the existing indicators in paragraphs 7-12 of IAS 17 *Leases*. For both finance and other-than-finance leases, the liability to make lease payments and the right-of-use asset would be initially measured at the present value of the lease payments. However, the pattern of expense recognition for a finance lease would be on an accelerated basis while the pattern of expense for an other-than-finance lease would be on a straight-line basis. The liability to make lease payments would be measured using the effective interest method and amortisation/depreciation of the right-of-use asset would be based on the difference between the straight-line amount and the interest expense amount, unless another systematic basis is more representative of the time pattern of the total lease expense. The interest and amortisation/depreciation expense amounts would be presented on a single-line item as rental expense in profit or loss.

The tentative decision to have two types of leases would address concerns expressed by financial services industry respondents regarding the accelerated expense recognition pattern for leases. Although the tentative decision would add a step to the analysis by requiring lessees to determine the appropriate classification of a lease, the Boards supported using the indicators in IAS 17 as a basis for determining lease classification. The Boards are expected to discuss the specific indicators for determining lease classification at a future meeting.

Contracts containing both lease and service components

The ED defines a lease as "a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration." The ED includes the following two principles, based on the existing guidance in IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, relating to that definition:

- the fulfilment of the contract depends on providing a specified asset or assets; and
- the contract conveys the right to control the use of a specified asset for an agreed period of time.

If a contract contains a lease, but also contains a service component, the ED would generally not apply to the "distinct" service components of a contract. A service component would be considered "distinct" if the entity or another entity either sells an identical or similar service separately or the entity could sell the service separately because the service has a distinct function and a distinct profit margin. Lessees and lessors would allocate the payments required under the contract between the distinct service and lease components in proportion to the standalone selling price of each component. However, if the lessee or lessor is unable to allocate the payments, the entire contract would be accounted for as a lease. If the service component is not distinct from the lease component, the entire contract would be accounted for as a lease.

Financial services industry respondents noted that the ED did not specify whether items such as property insurance, property taxes and maintenance would satisfy the distinct test; noting that property tax and property insurance are often a cost pass-through to the lessee and may not satisfy the distinct margin test, while maintenance may not be considered distinct in common area maintenance environments.

… the tentative decision to require separation of lease and non-lease components would require lessees to determine the lease and non-lease components of an arrangement.

In March 2011, the Boards tentatively decided that in contracts that include both lease and non-lease components, lessees and lessors would identify and separately account for the non-lease components in the contract. The distinct versus non-distinct guidance included in the ED would not be carried forward to the final standard. Further, the Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices. If the purchase price of one component in a contract that contains a lease is observable, a lessee would apply the residual method to allocate the price to the component for which there are no observable purchase prices. The Boards tentatively decided that lessees would treat the entire contract as a lease when there are no observable prices for any of the components.

The Boards' tentative decision to eliminate the distinct versus non-distinct guidance that was included in the ED addresses industry concerns about distinguishing between items that are distinct and not distinct. However, the tentative decision to require separation of lease and non-lease components would require lessees to determine the lease and non-lease components of an arrangement. Also, the tentative decision to allocate the payments required under the contract based on observable purchase prices will require lessees to obtain the information relating to the pricing of the components from lessors or other third party sources.

Variable lease payments

The ED would require the use of a probability-weighted expected outcome approach to estimate lease payments including contingent rentals, term option penalties and residual value guarantees. Many financial services industry respondents expressed concerns that the proposal would result in unreliable estimates and high volatility in earnings as a result of the required reassessment of the estimate.

In April 2011, the Boards tentatively decided that variable lease payments should not be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable unless the variable lease payments are disguised minimum lease payments. Disguised minimum lease payments are those variable lease payments that are structured in such a way that they are in-substance fixed lease payments. The final standard is expected to include guidance to assist in identifying disguised minimum lease payments.

The Boards' tentative decision to limit recognition of variable lease payments to disguised minimum lease payments addresses the concerns expressed by respondents. The Boards are expected to discuss possible disclosure requirements for variable lease payment arrangements in the near future.

Lease term

The ED defines the lease term as the "longest possible term that is more likely than not to occur." The comment letters overwhelmingly disagreed with this proposal because many respondents thought that a renewal option does not represent a liability until the lessee has actually exercised the option and estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options.

In February 2011, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a "significant economic incentive" for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Factors such as the existence of a bargain renewal option and a penalty for not renewing the lease would be considered in determining the lease term but past practice and management intent would not. The lease term would be reassessed only when there is a significant change in facts and circumstances.

The tentative decision to include renewal options in the lease term when there is a "significant economic incentive" to exercise the option represents a change from the ED because it raises the threshold for when renewal options would be included in the lease term. Judgement will be required, but the tentative decision is more closely aligned with IAS 17 that uses a "reasonably certain" threshold. The tentative decision to reassess the lease term would represent a change from the current guidance.

Looking ahead

The Boards still have a number of issues to discuss and will need to determine whether re-exposure of the proposals is necessary. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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