

Hot Topic

Update on major accounting
and auditing activities

Changes proposed for lease accounting

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Highlights

Substantial changes to the accounting for leases were proposed yesterday in the Exposure Draft (ED) issued by the FASB and IASB (the Boards) on their joint leases project. The ED proposes a single model that will be applied to most leases that will effectively end off-balance sheet reporting for leases. The proposed model also will require entities to make a number of estimates and periodically reassess those estimates in accounting for leases. As proposed, the guidance will affect existing leases at transition and no leases will 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 current guidance¹ relative to assessing whether an arrangement is or contains a lease. As a result, arrangements that are considered leases under existing accounting standards generally will be considered leases under the proposed standard.

How we see it

Although the criteria for determining what is or is not a lease is not changing, that determination for many arrangements will 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 will change under the ED which will require on-balance sheet accounting for all leases.

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¹ ASC 840-10-15 (formerly EITF 01-8).

Lessee accounting

Lessees will 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 will be based on the expected payments to be made over the lease term. Measurement of the expected payments will 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.

Subsequent measurement

The right-of-use asset is amortized over the lease term (or the useful life of the underlying asset if shorter) and would be subject to the impairment guidance for amortizing intangible assets. Interest expense on the liability to make lease payments would be recognized using the effective interest method, and lease payments would reduce the liability. For many leases, the total expense recognized (i.e., the sum of amortization and interest expense) will be higher in earlier periods of the lease and lower in later periods of the lease.

Lessees will be required to reassess the estimates and judgments 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 judgments used to determine lease obligations.

Transition

Lessees will need to recognize a liability to make lease payments and a right-of-use asset for outstanding leases at the date of initial application of the proposed guidance 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 guidance.

Lessor accounting

The ED proposes that lessors apply a right-of-use model using one of two approaches. For each lease, lessors will 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 will record an asset on the balance sheet representing their right to receive lease payments from the lessee. The lease receivable will 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. Leveraged lease accounting is not preserved.

A lessor will 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 will be used when the lessor has not retained exposure to significant risks or benefits associated with the underlying asset.

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 will retain the leased asset on its balance sheet and will record a lease liability (performance obligation) for its obligation to permit the lessee to use the leased asset. The lease liability will initially equal the lease

receivable (less any initial direct costs incurred by the lessor), and the lessor will recognize revenue as the lease liability is satisfied over the term of the lease. Revenue is recognized 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 will not recognize any lease 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 will recognize revenue on a straight-line basis similar to the accounting for operating leases under the current model. Interest income on the lease receivable will be recognized over the lease term using the effective interest method. Lessors will continue to depreciate the leased asset, and the asset will 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 will derecognize 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 will be allocated to a residual asset. The allocation of the carrying amount between the derecognized amount and the residual asset will be determined on a relative fair value basis at the inception of the lease. The residual asset will 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 recognizing some measure of income (or loss) as of the start of the lease. Interest income on the lease receivable will be recognized over the lease term using the effective interest method.

Transition

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

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

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

Other proposed changes

Sale-leasebacks

Sale-leaseback transactions will no longer provide off-balance sheet financing as all leases would be recorded on the 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

The ED includes implementation guidance similar to the stringent rules that currently exist for sale-leasebacks of real estate; however, these criteria will be applicable for all sale-leasebacks (i.e., sale-leaseback of both real estate and non-real estate assets). 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 criteria included in the ED could result in many more transactions being accounted for as financings (i.e., as a borrowing by the seller-lessee and a lending by the buyer-lessor) than under current practice.

Subleases

In a sublease arrangement one party (the intermediate lessor) will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease, and it will act 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 guidance for the assets and liabilities that arise in a sublease. The lessee accounting model will be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model will 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 underway. 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 analyze the proposed model and the effect it may have on them and 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. For a more detailed look at the ED, refer to our Technical Line, *Proposed leases guidance exposed* (18 August 2010, SCORE No. BB1990).

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