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Financial INSIGHT
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A new lease on life – Update on Accounting for Leases

1. Overview

On 17 August 2010, the International Accounting Standards Board (“IASB”) and Financial Accounting Standards Board (“FASB”) released an Exposure Draft (“ED”) on lease accounting.

The AASB subsequently issued the same exposure draft (ED 202R) for which public comment closed on 12 November 2010. The ED proposes major changes to accounting for leases with the most notable change being the removal of the differentiation between operating and finance leases; the result being a single model for lessee accounting. The proposed changes outlined in the ED are to replace *AASB 117 Leases*. Submissions to the IASB and FASB closed 15 December 2010, and have now been collated and made publicly available on the FASB website.

At their joint meeting on 19 January 2011, the IASB and FASB considered a plan for the redeliberation of issues identified by respondents in comment letters.

This Financial INSIGHT provides an overview of the changes proposed and the main issues identified which will be redeliberated.

2. Overview of Lessee Accounting under the ED

Scope of the Proposals

The proposed standard would apply to all leases including leases of a right of use asset in a sublease, except:

- leases of intangible assets within the scope of *AASB 138 Intangible Assets*
- leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources within the scope of *AASB 6 Exploration for and Evaluation of Mineral Resources*
- leases of biological assets within the scope of *AASB 141 Agriculture*; and
- leases between the date of inception and the date of commencement of a lease if they meet the definition of an onerous contract under *AASB 137 Provisions, Contingent Liabilities and Contingent Assets*.

Key Concepts

Under the proposals of the ED, regardless of whether the lease is classified as an ‘operating’ or ‘finance’ lease under *AASB 117 Leases*, (“AASB 117”) one accounting model will be applied to all leases. In summary the main requirements for accounting for leases will involve:

- Initially all lease contracts which fall under the ED’s definition of a ‘lease’ will recognise a ‘right-of-use asset’ and a corresponding liability to make lease payments.

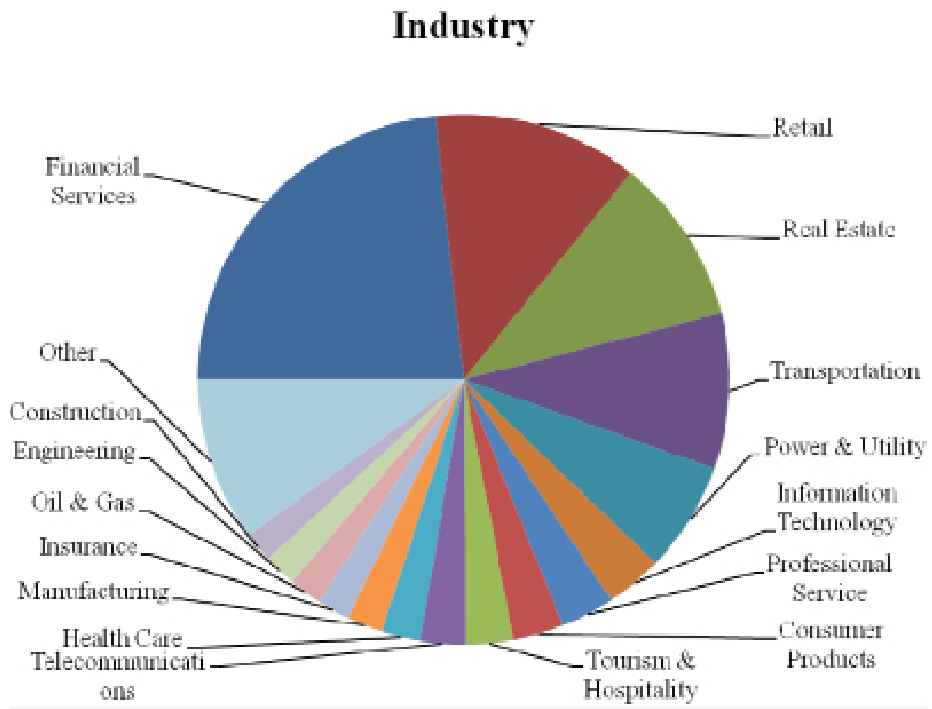
- The value of the liability will be the present value of the lease payments discounted using the interest rate the lessor charges in the contract, or the lessee's incremental borrowing rate. The lease period used in the calculation will not be restricted to the contract period, but will include consideration of any options to extend or terminate the lease. The lease term will be the longest possible term that is more likely than not to occur.
- Contingent rental amounts are required to be included in the calculation of the liability, which is the probability-weighted average cash flows for a reasonable number of possible outcomes.
- The right of use asset is then equal to the liability plus any initial direct costs, as defined in the ED, which are incurred by the lessee.
- After the initial recognition, the right-of-use asset is generally amortised on a straight line basis over the estimated life of the lease. The liability is measured at amortised cost using the effective interest method, which is similar to the way in which a lease liability under a finance lease is currently measured and amortised.

3. Industries most likely to be impacted

Currently 'operating leases' are effectively held 'off balance-sheet', whereas under the proposal a right of use asset and lease liability will be recognised for all leases. Therefore the financial statements of any company that currently holds 'operating leases' will be affected. A large portion of entities hold operating leases in the form of the rental of, buildings, office equipment, vehicles, plant and machinery. The greatest effect on your organisation will be where a high value or high volume of operating leases has been entered into. This is due to the fact that operating lease payments were simple to account for, by recording the rental / lease expense when due. In contrast the accounting under the ED will require more judgement, more complex calculations and more journal entries over the term of the lease. Applying the ED to an existing operating lease generally results in higher expenses in the early stages of the lease contract, and lower expenses in the later stages which impact the profit and loss recognition pattern. Given the impacts the industry's most heavily impacted will be:

- Retail
- Airline
- Shipping
- Other transport
- Real Estate
- Power and Utility
- Construction
- Information Technology
- Manufacturing

The large impact on these industries was reflected by the responses received to the exposure draft.



Source: IASB/FASB Meeting January 2011, Agenda reference 5A, FASB memo 123.

4. Issues identified in comment letters

The IASB and FASB received a total of 760 comment letters in the four month comment period for the ED. The high level of respondents from a range of industries as outlined above indicates the wide reaching impacts of the proposals.

RSM International lodged an extensive submission to the IASB which outlined both our support for some aspects but also aspects we identified that required further guidance and improvement. These included:

- Given the additional complexity in performing calculations for relatively simple lease arrangements, the cost of compliance is a concern
- The ED proposed that for lessor accounting two models would exist for application under different lease terms. The application of one of the models may result in two assets (the underlying asset and right to lease payments) being bought to account for a single lease contract. Our submission outlined that a single model approach would be preferred as the two models with the option of using a hybrid model adds an additional layer of complexity; and
- A simplified approach for accounting for short term leases is outlined in the ED, however its use was restricted to lessor accounting. Our comments included a recommendation that this accounting should be extended to lessee accounting.

These views were consistently outlined in submissions by other respondents.

5. Where to from here?

On the 19th of January 2011 the FASB and IASB held a joint meeting to discuss constituent's responses to the ED. At this meeting a summary paper of ED responses and a redeliberation plan moving forward was tabled. The redeliberation plan identified five main issues in the initial ED, which were surrounding:

- The definition of a lease
- Lessor accounting model
- Lease term
- Variable lease payments; and
- Profit and loss recognition pattern.

No decisions were made at the meeting as the IASB and FASB staff are assessing which matters will require reconsideration and which matters they will confirm as unchanged. A further meeting was held on 1 February 2011; however this meeting was for educational purposes only and focused specifically on distinguishing a service contract from a lease. No decisions were reached at this meeting.

Other subsequent meetings held and their impact on the proposed standard is:

- 16 February 2011, joint FASB and IASB meeting: at this meeting a tentative decision was reached to redefine lease term from "the longest possible term that is more likely than not to occur" to "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 significant economic incentive for an entity not to exercise an option to terminate the lease" This should have the effect of reducing the length of lease terms and also reducing the assumptions required to determine the lease term.
- 17 February 2011, joint FASB and IASB meeting: in part one of the meeting, tentative decisions were made surrounding more technical aspects of the ED. The majority of these changes will have little impact on accounting for leases in the majority of cases. At part two of the meeting a major decision was made surrounding the lease models of recognising expenses and revenues. The modified models will be used to perform further outreach and industry consultation. A tentative decision was to allow two different types of leases with different profit and loss effect being:
    - "A finance lease with a profit or loss recognition pattern consistent with the proposals in the exposure draft
    - An other-than-finance lease with a profit or loss recognition pattern consistent with an operating lease under existing IFRS/US GAAP. "

The decision will affect the recognition of profit and loss only and will not change the fact that all lease assets and liabilities will be required to be recorded on the balance sheet. For example the other-than-finance leases will still be recognised as a right of use asset and a lease liability, however the lease expense will be recognised on a straight line basis rather than using the more complex model in the initial ED.

We will keep you informed as matters progress and the joint bodies make further decisions on the proposed leases standard.