Proposed overhaul of accounting for leases – a significant issue for the energy and resources sector

Application date: A final standard is expected in the first half of 2012. The application date is yet to be determined.

What is the issue?

On 17 August 2010 the International Accounting Standards Board and Financial Accounting Standards Board (the "boards") issued the Exposure Draft *Leases* (ED). The ED outlines a new accounting model that would significantly transform lease accounting and affect almost every business within the energy & resources industry.

Specifically, the ED proposes a new model whereby a lessee's rights and obligations under existing and new leases, would be recognised on the balance sheet.

The proposals require lessees to estimate the lease term and contingent payments at the beginning of the lease then re-assess the estimates throughout the lease term. This activity will require more effort and judgement than under existing standards.

During the ED's comment period, the boards received a staggering 781 formal responses to the proposals. This emphasises the significant impact of the proposed guidance across all industries (key themes highlighted in the response letters are discussed in the following pages). The boards are now using the response letters and feedback from outreach activities to address common issues raised and finalise the standard.

In particular, the boards have identified the following areas to focus on in their re-deliberations: the definition of a lease, lease term, lease payments, and timing of expense recognition. Although the boards originally proposed a dual model for lessors, following re-deliberations they have determined that lessor accounting is not 'broken'. Therefore, the boards have decided that the new leasing standard will not include changes to existing lessor accounting practices.

The boards are aiming to issue the final standard in H1 2012. A re-exposure or review draft is expected in Q3 2011.

Note. In this document we consider the proposed changes to accounting for leases in the Exposure Draft and tentative decisions made to date. Any conclusions noted here are subject to further interpretation and assessment based on the final standard. Talk to your usual PwC contact for latest updates.

Why is this significant for the energy and resources sector?

If adopted, the proposals will have pervasive business and accounting impacts. In particular, the impact on financial reporting could be substantial in the energy and resources sector. For example:

- **Expense recognition patterns will change**. Cash payments versus expense recognition will further diverge, particularly for long leases (such as leases over machinery and equipment). While cash payments remain unchanged, the profit or loss will reflect a front-loading of expense with higher expenses recorded in earlier years. Management's judgement concerning certain contingent rents, such as lease payments which are based on mileage or linked to inflationary increases, may produce income statement volatility which will affect performance measurement. The changes will be welcomed by industry analyst as differences cash and non-cash costs arising from asset purchasing strategy (operating versus finance leases) are eliminated.
- **Most leases will generate a liability for lessees**. Analysts and credit agencies are underestimating the significance of the liability when adding back "debt-like" items for operating leases. A material

lease liability could be added to the balance sheet for significant capital items (such as power stations and related mine infrastructure, drilling machinery, mining and haulage fleet, and other service arrangements which may contain "embedded leases"). As a result, key financial ratios and debt covenants could be impacted.

- **Decision points and data needs will change**. Structuring consideration will change to focus on liability and volatility reduction as opposed to obtaining operating lease treatment. Data needs for ongoing reporting will change significantly.
- **Lease-versus-buy decisions should be revisited**. Without the desired accounting treatment for operating leases, management may prefer to purchase assets rather than enter into lease arrangements, in particular for leases of small ticket items such as computers or office equipment. Lessors may want to consider how these proposals might affect their business strategies.
- **IT systems and internal processes may need updating**. Manually tracking lease portfolios in spreadsheets or pre-packaged software may not easily accommodate the proposals. Broadly speaking, industry-wide neglect of leasing software and systems may necessitate upgrades and enhancements. These upgrades should be considered (and budgeted for) in advance by all energy and resources entities.

What are the overarching proposals?

The key elements of the proposals and their effect on financial statements are as follows.

Lessee accounting

The proposals effectively eliminate off-balance sheet or operating lease accounting for most leases. Most assets currently leased under operating leases would be brought onto the balance sheet, removing the distinction between finance and operating leases. The board is currently considering if leases that have a period of 12 months or less should continue being treated as operating leases in a way that we are currently familiar with under existing leasing accounting rules. Many in the energy and resources sector have been surprised that under the proposals the measurement of the right-of-use asset and lease liability is different to existing finance lease accounting because lease payments need to incorporate an estimate of certain variable rents.

The significant impacts of the proposals are listed below.

- A right-of-use asset (representing the right to use the leased item for the lease term) and an obligation (representing the obligation to pay rentals) would be recognised and carried at amortised cost, based on the present value of payments over the term of the lease.
- During re-deliberations, the boards tentatively decided to raise the threshold of extension options in the lease term to those that provide "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. In practice, this means that lease terms may be similar to those determined under the existing standards. However, determining whether a renewal option is expected to be exercised is not dependent on management intent or past practice; rather it is based on whether a significant economic incentive exists at the time of the assessment.
- Under the ED, the use of an 'expected outcome' approach to estimate lease payments was proposed in order to measure the initial value of the lease asset and liability. This approach would include consideration of certain contingent amounts, such as rents linked to variables such as the Consumer Price Index (CPI). However, in recent re-deliberations, the boards have tentatively decided that the estimate should only include contingencies that are: i) based on a rate or index; ii) are "disguised" as a fixed lease payment; and iii) have residual value guarantees which are expected to be paid. This would mean that estimated lease payments will not be subject to judgement as much as originally proposed in the ED.
- Under the ED, lease renewals and contingent rents would need to be continually reassessed by entities, and the related estimates adjusted as facts and circumstances change. However, in recent re-deliberations, the boards have decided that reassessment of the lease term should be performed only under certain circumstances. This would substantially reduce the time entities would need to invest in reviewing estimates and updating correlating numbers; it was a common issue raised by entities in response to the proposals.

Presentation and disclosure

Due to the significantly expanded use of estimates and judgements in the proposals, disclosure requirements will go well beyond those required under the current leasing standard. Quantitative and qualitative financial information that identifies and explains the amounts recognised in financial statements arising from lease contracts and a description of how leases may affect the amount, timing, and uncertainty of the entity's future cash flows would be required.

Additional specific disclosures may also be required. For example, a description of the nature of an entity's

leasing arrangements, the existence and terms of optional renewal periods and contingent rentals, and information about assumptions and judgements. In addition, any restrictions imposed by lease arrangements, such as dividends, additional debt, and further leasing would also need to be disclosed.

Some of the resources entities that we have been engaging with have been surprised to learn that the following disclosures would also be required under the proposals.

- Information about the principal terms of any lease that has not yet commenced where the lease creates significant rights and obligations.
- A reconciliation between the opening and closing balances of right-of-use assets and obligations to pay rentals, disaggregated by class of underlying asset.
- A narrative disclosure of significant assumptions and judgements relating to renewal options, contingent cash flows, and the discount rate used.
- A maturity analysis of the gross obligation to pay rentals showing: (i) undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years; and (ii) amounts attributable to the minimum amounts specified in the lease and the amounts recognised in the balance sheet.
- Additional disclosures would apply if: (a) the simplified option for short-term leases is elected; (b) significant subleases exist; or (c) there is a sale-leaseback transaction.

For some entities, the proposed disclosure requirements would involve a significant data gathering (and maintenance) exercise. In practice - and across the energy & resources sector as a whole - we expect that meeting these disclosure requirements would require a significant amount of time and effort.

How would typical terms & conditions in the energy and resources sector be affected?

Terms	Example	Existing accounting	New accounting	Potential impact on the Energy and resources sector
CPI escalations	On-site office tenant has a rent escalation each anniversary date based on the change in the published Consumer Price Index.	Treated as contingent rent, which is not included in "minimum lease payments" used for straight line rent purpose but rather the expense is recognised in each annual period based on actual increase in that period.	The new standard would require the office tenant to include CPI escalations using the spot rate to measure its lease liability under these provisions for whatever lease term is utilised (including potential extension options) and include them in the calculations.	CPI escalation provision features will no longer have advantageous accounting for lessees. We expect that the use of such provisions may be reduced in practice if for no other reason than to reduce complexity. Further, from a risk standpoint, if a tenant that expects 3% inflation can get similar accounting for a fixed rent step of 3%, all other things being equal, they would lower their risks and complexity by moving to a fixed rent strategy.
Percentage rent	Lessee pays variable rent for trucks based on usage (ie., number of kilometers travelled).	Treated as contingent rent which is not included in "minimum lease payments" used for straight-line rent purpose but rather the expense is recognised based on actual sales when it becomes probable that annual sales will exceed $10 million.	Treatment of performance or usage based variable rents will probably remain similar to current practice. These rents will continue to be excluded from the measurement of lease payments.	For more predictable operations, percentage rent features may have an advantageous accounting for lessees.
Termination rights	A lessee is uncertain about the remaining life	Frequently these are considered 10-year leases	Lease term probably similar to current	With the tentative decisions from the

Terms	Example	Existing accounting	New accounting	Potential impact on the Energy and resources sector
	of mine. They sign a 10-year lease with the right to terminate the lease after two years.	because of the penalties from having to walk away from the tenant improvements.	practice. A similar lease could be structured as a two-year lease with a right to extend for 8 years. The new model will evaluate the expected term as either 2 years or 10 years based on the probability of the lease running for those periods.	Boards on lease terms, leases may be structured with shorter original lease terms with options to extend rather than termination rights. A lease term must include any periods with significant economic incentive to extend. A significant termination option may be considered to be a 'significant economic incentive'. Closer to the end of the mine life, companies may prefer to have extension options rather than termination options.

Summary of comments on the proposals

There are a number of recurring themes in the response letters to the leasing proposals and IASB outreach roundtable discussions, across industries and within the automotive industry specifically. While a majority of the respondents are supportive of the need for the project in general (particularly in relation to lessee accounting) most respondents raised significant concerns about many aspects of the proposals. Many respondents strongly encouraged the boards to take the time necessary to produce a standard that is both high quality and operational, and reflective of the needs of the international business and investor community.

Some of the common points expressed in the response letters to the boards are shared below.

- **Lessee accounting.** Many respondents supported the right-of-use model for lessees, at least with respect to the balance sheet implications for simple leases.
- **Lessor accounting.** Many respondents indicated they did not believe the current lessor accounting model was fundamentally broken.
- **Lease term.** Almost all respondents disagreed with the definition of lease term as the longest possible term "more-likely-than-not" to occur. The boards have since revised the definition of 'lease term' to be the non-cancellable lease term taking into consideration significant economic incentives for renewal loans.
- **Lease payments.** Most respondents were critical of a probability-weighted approach; the boards have since revised the approach to use a more appropriate "best estimate" approach. Some respondents also believe that certain types of contingencies (eg, usage, performance, or index-based) should be treated differently depending on whether the variable lease payment is within management's discretion.
- **Expense recognition for lessees.** Many respondents questioned the usefulness of this model. This model results in a recognition pattern for the lessee that changes the expense recognition pattern of operating leases from rental expense to a combination of amortisation and interest expense. The boards have since recognised that there are two different types of leases: financing and 'other-than-financing'. Financing leases will continue to recognise amortisation and interest expense, whereas 'other-than-financing' leases will continue to have straight-line expense recognition.
- **Leases versus service contracts.** Many respondents (both from the lessee and lessor perspective) had concerns about accounting for an "embedded lease" in a multiple-element arrangement in which the vendor can replace the underlying asset or where there is no specific asset identified in the contract (eg, leases mining and haulage fleet with scheduled maintenance services). Multiple-element contracts that include a lease and a service arrangement (such as special purpose plants operated by service providers) are a significant concern to many. Many respondents believe the standard should specifically exclude service and executory costs from lease payments rather than try to link to the definition of a distinct service under the revenue recognition Exposure Draft. The boards continue to re-deliberate on this point.

- **Reassessment of lease terms and conditions.** Many respondents raised concerns about the operationality and cost/benefit of this approach. These respondents indicated that an annual reassessment may be appropriate while others suggested a "trigger-based" reassessment.
- **Disclosure.** Most respondents supported the overall disclosure objectives, but believe that preparers should be allowed to exercise judgement in determining the volume of disclosures and financial statement presentation to address cost/benefit concerns.

Is management ready for the changes?

Results from the Impact Survey 2010

Last year PwCperformed an impact survey to understand the reactions and perceptions of entities with respect to the proposed overhaul of lease accounting. The survey was conducted in cooperation with the Rotterdam School of Management, Erasmus University. More than eight countries from fourteen industries participated in the survey. Highlights from the survey included:

- The majority of respondents (74%) are unaware of the negative impact on net earnings in the first years after transition
- The majority of respondents said they do not currently have or only to a limited extent have the necessary information and data (68%), resources (74%), process (78%) and IT systems (76%) in place to implement the proposals
- Nearly half of respondents are unable to assess to what extent changes are needed to business models, business and financial processes, IT systems, reporting and closing processes, internal controls, performance measurement systems and budgeting and tax planning strategies
- 40% of respondents will not continue leasing real estate property in the same way as today. 22% expect to move to shorter leases. For other leases, approximately half of respondents will not continue leasing the same way as today.

What should companies be doing now?

- Inventory existing leases and perform an assessment to determine the impacts of the proposed standard to your company.
- Evaluate existing IT systems and hold discussions with IT providers to assess the system's current capabilities, and whether upgrades are both necessary and available.
- Consider the impacts of the new rules upon major company initiatives, such as systems and compensation plans.
- Begin to assess what data will need to be collected and analysed prior to adopting the standard, to allow for a comparative presentation.
- Consider the impacts on "lease versus buy" strategies.
- Establish a training and communication plan with employees and key stakeholders.

Online lease accounting survey

An online survey is now available for entities to use across all industries. Through this survey, clients will be able to gain high level insight into the potential impacts of the proposed changes to lease accounting on their organisation and its readiness for the implementation of the new standards.

Entities can access the survey through the PwC website www.au.pwc.com/leasediagnostic

Impact assessment tool

In addition to the survey, an impact assessment tool has been developed to perform a more detailed assessment of the new leasing requirements. The objective is to provide a quantitative and qualitative assessment of the impact on key financial metrics and provides comparison to the existing leases approach over a specified timeframe.

Entities should contact their usual PwC representative to use the impact assessment tool.