Leasing – overhauling lease accounting
Latest instalment: a joint IASB/FASB exposure draft

At a glance

- The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) released an exposure draft on 17 August 2010 that will significantly change lease accounting and is expected to impact almost all entities.

- The exposure draft proposes a new model for lessee accounting under which a lessee’s rights and obligations under all leases, existing and new, would be recognised on the balance sheet.

- The boards are proposing a dual model for lessors, under which a lessor would need to apply either a performance obligation approach or a derecognition approach, depending on whether the lessor retains exposure to significant risks and benefits associated with the underlying leased item.

- The proposal would require lessees and lessors to estimate the lease term and contingent payments at the beginning of the lease and re-assess the estimates throughout the lease term; this entails more effort and judgement than under existing standards.

- The boards expect to issue a final standard in 2011. The effective date has not yet been determined but could be as early as 2014. The boards are consulting separately on potential adoption dates for this and other major convergence projects nearing completion.

- Management should begin to plan now for its potential impact due to the proposed standard’s business implications, including contract negotiations and the impact on key metrics, systems and processes.
The main details

1. As part of their global convergence process, the boards' objective of a new leasing standard is to provide information in the financial statements about the amounts, timing and uncertainty of cash flows arising from lease contracts. The proposals will significantly change lease accounting. For lessees, the balance sheet will be grossed up to report a leased asset and lease obligation. In addition, straight-line rent expense will generally be replaced by amortisation of the leased asset and interest expense on the lease obligation on an effective interest basis. Hence, total expense will be front-loaded compared to the current practice.

PwC observation: Research completed by PwC and the Rotterdam School of Management has quantified the impact of the proposals on financial ratios reported by 3,000 entities worldwide. The expected impact of the proposed changes to lease accounting is that interest-bearing debt and leverage will increase, but so will earnings before interest, tax, depreciation and amortisation (EBITDA). The increases will be substantial for certain entities. For more detail, see from paragraph 65 below.

2. The proposals require both lessees and lessors to reassess estimates of the lease term and cash flows as facts and circumstances change. As a result, significantly more effort will be required to account for leases initially and on an on-going basis. Greater investment by preparers in systems and processes may also be needed to support the accounting. Because virtually all entities enter into lease arrangements, the new model will have a pervasive impact. Management should therefore continue to follow the project and plan for implementation.

PwC observation: Management will need to undertake an in-depth review of the proposed changes in order to assess the impact on financial performance ratios (including debt covenants), taxation and compliance with the proposed standard. The changes will require more information to be gathered and more judgements to be made on an annual basis. They will affect financial ratios and metrics, ‘lease-buy’ decisions, taxes, accounting processes and controls, and IT and lease accounting systems.

Lessees may need to consider re-negotiating or restructuring existing and future leases. Business and legal structures supporting leases should also be reassessed to evaluate whether these continue to be effective (for example, joint ventures and special purpose entities).

The development may also significantly impact current lessors’ business models. Lessors will need to emphasise the continuing benefits of leasing, and consider the implications for lessees and whether existing products need to be revised.

3. This guidance explores the proposed standard. The comment period ends on 15 December 2010.

4. The boards' conclusions in the exposure draft are tentative and subject to change until they issue a final standard.

Key provisions

Scope

5. The boards propose to include in the scope of the leasing standard leases of property, plant and equipment and not leases of intangible assets. The boards also propose to exclude the following from the scope:

- Leases to explore for or use natural resources (such as minerals, oil, and natural gas).
- Leases of biological assets.
- Leases of investment property measured at fair value under IAS 40, ‘Investment property’.

6. The scope of a proposed standard will align with current US generally accepted accounting principles but will differ from current IFRS.
**PwC observations:** Similar to other standards, the proposed lease standard would not apply to immaterial items. Although a single item might be immaterial, items of a similar nature might be material in the aggregate (that is, one computer lease might be immaterial, but 10,000 computer leases might be material). For leases determined to be immaterial to the financial statements in the aggregate, management may consider developing a policy similar to those commonly used for property, plant and equipment where only expenditure over a certain amount is considered for capitalisation.

Intangible assets are not within the scope of the proposed leasing standard. Instead, they will be accounted for in accordance with the proposals in the exposure draft ‘Revenue from contracts with customers’. This scope exclusion results in a number of accounting differences, such as how to account for initial direct costs. Such costs would be capitalised under the proposed leasing standard but expensed under the proposed revenue standard.

### Short-term leases and non-core assets

7. The boards considered the potential exclusion of short-term leases and leases of non-core assets. Factors included in their considerations were the cost of applying the model, the difficulty in defining non-core assets and the potential structuring opportunity that an exclusion could create. They propose not to exclude short-term leases or leases of non-core assets, as these leases may give rise to material assets and liabilities; if so, excluding them would run counter to the board’s objective of bringing the rights and obligations on the balance sheet.

8. Although the boards granted no exclusion for short-term leases, they propose the use of a simplified method of accounting. For leases with a maximum possible term (including all extension options) of 12 months or less at inception of the lease, lessees would recognise a lease asset and liability equal to the gross payments remaining on each lease. Lessors, on the other hand, would not recognise any lease assets or liabilities but would continue to recognise the underlying asset. Both lessees and lessors would recognise payments for the lease in the income statement over the lease term.

**PwC observation:** Because of the short duration of the leases that qualify for the simplified approach, the time-value of money associated with those short-term leases would be ignored as a practical expedient.

The exposure draft does not explicitly state how lease payments for short-term leases under the simplified approach would be reported in the income statement (that is, as rent expense or amortisation expense). However, we expect that if the asset is being recorded and amortised, the amount included in the income statement would represent amortisation expense. Any payments to the lessor would reduce the obligation.

### Arrangements containing both lease and service components

9. The scope also includes leases contained within other arrangements, such as service or supply contracts. Existing guidance on when such a contract conveys the right to control the use of the underlying asset is included in IFRIC 4, ‘Determining whether an arrangement contains a lease’. Similar guidance is included in the proposed standard; as a result, a right to control the use of an underlying asset would be considered an embedded lease and reflected on the lessee’s balance sheet.

**PwC observation:** The embedded leases within these arrangements are often classified as operating leases under current guidance. Because the accounting is similar for a service or supply arrangement and an operating lease, there is little tension around separating the two components today. This will change when the embedded lease is brought on the balance sheet under the right-of-use model. Considerably more analysis may therefore be required compared with current practice.

10. For lease contracts that contain both service and lease components, a determination of whether the service is considered distinct would be required. Total payments under the arrangement would be allocated between distinct service and lease components using the same principles proposed in the exposure draft, ‘Revenue from contracts with customers’. If services are not considered distinct, or if total payments cannot be allocated among the service and lease component, the entire arrangement would be accounted for as a lease.
PwC observation: The proposals in the revenue exposure draft consider a service distinct if either:
(i) the entity, or another entity, sells an identical or similar service separately; or
(ii) the entity could sell the service separately because it has a distinct function and a distinct profit margin.

The definition of distinct service components may present difficulties for lessees to separate executory costs/services from the lease component. Executory costs and service components (for example, common area maintenance, security charges, insurance and property taxes), if not considered distinct, would be included in the asset and liability recorded on the balance sheet. This would differ from the accounting treatment if the asset were owned. It will be a major issue for many significant users of real estate and time charter shipping entities.

In-substance sales and purchases

11. The boards recognise that some contracts may be leases in legal form but are, in substance, sales contracts under which the lessor has ceded control of the underlying leased asset to the lessee. For this purpose, determining who has control is based on the risks and/or benefits retained by the lessor at the end of the contract. Contracts would be considered a purchase or sale if, at the end of the contract, an entity transfers control of the asset and has retained no more than a trivial amount of the risks or benefits. For example, this would include contracts that automatically transfer title at the end of the lease and contracts that have a bargain purchase option that is reasonably certain to be exercised.

PwC observation: Agreements meeting these conditions would be considered a sale and a purchase rather than a lease and would be excluded from the scope of a proposed standard. The determination would be made at the inception of the contract and would not be revisited. For lessee, this will not result in a significant change from how these transactions would be accounted for if they were within the scope of the leasing standard. For lessors, if the contract is considered a sale, the transaction would follow the revenue recognition guidance.

Lessee accounting

The basic model

12. The boards propose a right-of-use model for lessee accounting. This model requires the lessee to recognise an asset representing its right to use the leased item for the lease term and a corresponding liability for the obligation to pay rentals at the commencement date of the lease. All leases would be accounted for in a similar manner under this approach; the classifications of finance and operating leases used today would be eliminated.

13. The boards believe that the right-of-use model is the most consistent with their conceptual frameworks and increases the transparency of lease accounting. Because leases are commonly viewed as a form of financing, the obligations recognised on the balance sheet under the right-of-use approach would be consistent with how businesses reflect other financing arrangements.

PwC observation: The right-of-use model might change how entities negotiate leases, and it might affect lease-versus-buy decisions. However, we believe leasing will continue for a variety of business reasons. Leasing provides more operational flexibility than outright ownership; certain leasing structures are more tax-efficient than direct ownership; and leasing often provides effective financing to entities whose financing options are otherwise limited. In addition, for large-ticket items, such as real estate, leasing is expected to continue as a viable option because many companies prefer not to own these types of asset, or the specific asset may only be available through leasing (for example, a specific retail location).

Initial measurement

14. Lessees would initially measure the right-of-use asset and the obligation to pay rentals at 'cost'. Cost is defined as the present value of the lease payments, plus, in the case of the right-of-use asset, initial direct costs incurred by the lessee. The boards have defined initial direct costs as incremental costs directly attributable to negotiating and arranging a lease. For example, initial direct costs include: commissions, legal
fees, negotiating lease terms, preparing and processing lease documents, closing the transaction and other internal costs that are incremental and directly attributable to negotiating and arranging the lease.

15. Present values would be determined using the lessee's incremental borrowing rate as the discount rate at the date of inception of the lease. If the rate the lessor is charging implicit in the lease is readily determinable, this rate can be used in lieu of the incremental borrowing rate.

**PwC observation:** Lessees would not be obliged to seek out the rate the lessor is charging in the lease and will often not have insight to be able to identify that rate. The rate the lessor is charging is more likely to be identifiable in equipment leases, particularly when the equipment also may be purchased outright. For other types of lease – including real estate leases with rents based on cost per square foot – the lessee rarely knows the implicit rate the lessor is charging. Nonetheless, the boards have proposed to grant lessees the option to use the rate the lessor's is charging, if known. They did so because in certain circumstances it may be more cost effective for the lessee to use the rate the lessor is charging in the lease rather than determine its incremental borrowing rate.

The boards proposed that measurement of the lease occur at lease inception (that is, the earlier of the date of the lease agreement or the date of commitment). However, the asset and corresponding liability are not recognised until the commencement date of the lease (the date on which the lessor makes the leased asset available). The exposure draft does not address the accounting for the change in present value of the obligation when a significant amount of time passes between lease inception and lease commencement. We believe that the asset and liability should be adjusted at commencement to eliminate this differential.

### Subsequent measurement

16. The boards propose that the right-of-use asset should be subsequently measured at amortised cost. The expense would be presented as amortisation expense rather than rent expense. The lessee's obligation to pay rentals would also be subsequently measured at amortised cost using the effective interest rate method under which payments would be allocated between principal and interest over the lease term. The total of amortisation and interest expense determined under that method would be higher in the early years of a lease compared to the current straight-line treatment for rent expense. (See example in paragraph 26.)

**PwC observation:** These changes will affect balance sheet ratios and income statement metrics. EBITDA will increase, perhaps dramatically, in the absence of rent expense. The changes in metrics may also affect loan covenants, credit ratings and other external measures of financial strength. Internal measures used for budgeting, incentive and compensation plans and other financial decisions may similarly be affected. For more detail, see from paragraph 65 below.

17. A lessee may measure its right-of-use assets at fair value if it revalues all of its owned assets in the same class of property, plant and equipment. Gains and losses on revaluation would be recognised in other comprehensive income.

### Lease term

18. Under existing standards, optional periods are considered part of the lease term if the lessee concludes at lease inception that it is ‘reasonably certain’ to exercise the right to renew the lease for the optional periods. Under the right-of-use model, lessees would be required to estimate the ultimate expected lease term and periodically reassess that estimate. A detailed examination of every lease at each reporting date would not be required. A lease's term would be re-examined only if changes in facts and circumstances indicate that there would be a significant change in the liability since the previous reporting period.

19. The lease term is defined as the longest possible term more likely than not to occur. In estimating the lease term, all relevant factors should be considered, including contractual, non-contractual and business factors as well as intentions and past practices. For example, consider a lease with a non-cancellable, five-year term and two five-year renewal options. The minimum contractual term of five years is more likely than not to occur (the probability is 100% that the lease will cover at least the initial five-year period). The lessee would also need to consider whether the 10- or 15-year terms available as a result of the renewal options are more likely than not to occur. Once the lessee has determined which lease terms are more likely than not to occur, the longest of those terms would be the lease term used to account for the lease.
PwC observation: The change in how lease renewal options are measured from a ‘reasonably certain’ hurdle to a ‘more likely than not’ hurdle will increase the length of lease recognised in many instances, as the threshold for recognition is significantly lower.

Purchase options

20. The boards propose that purchase options would be not be accounted for in the same manner as options to extend a lease. Instead, purchase options would be recognised only upon exercise. At that time, the exercise of a purchase option would result in the lessee recognising the underlying asset and derecognising any unamortised right-of-use asset.

PwC observation: This decision reflects the boards’ view that a purchase option goes beyond conveying the right to use an asset for a specified period; the purchase should therefore be accounted for separately.

Contingent cash flows

21. Under existing standards, contingent rentals are generally recognised as expenses in the period incurred. The right-of-use model would require that the initial measurement of the obligation to pay rentals include contingent cash flows, such as ‘turnover rents’, increases in rents based on changes in an index (such as CPI) and residual value guarantees.

22. The boards propose to use an expected outcome technique for measuring contingent cash flows, with the clarification that a lessee does not have to consider every possible scenario. This technique requires the lessee to consider reasonable number of possible outcomes while stopping short of a formal probability-weighting process.

PwC observation: Many respondents to the boards’ March 2009 leases discussion paper disagreed with the inclusion of lease renewal options and contingent rentals in measuring the right-of-use asset and lease liability. They argued that options and contingent payments are not the same as a commitment and therefore do not meet the definition of a liability. In the exposure draft’s Basis for Conclusions, the boards believe that contingent rentals and renewal options meet the definition of a liability. They argue that not reflecting contingent rentals and options in the measure of the lease obligation would result in the non-recognition of payments due to the lessor and could result in structuring opportunities to avoid recognising an obligation.

Changes in estimates and remeasurement

23. The boards propose that lessees would be required to reassess estimates of lease term and contingent cash flows as warranted by changes in facts and circumstances. Subsequent measurement of the lease obligation would reflect all such changes in estimate. Changes in the lessee's obligation due to a reassessment of the lease term would be recognised through an adjustment of the right-of-use asset.

24. The boards propose a mixed model approach for changes in estimated contingent cash flows. Where changes in amounts payable under contingent cash flow arrangements are based on current or prior period events or activities, those changes would be recognised in profit or loss. All other changes would be recognised as an adjustment to the lessee's right-of-use asset. For example, consider a lessee that enters into a 10-year lease agreement that includes rental payments based on a percentage of sales. During the second year of the lease, the lessee determines that the original estimated sales figures require updating. Adjustments in the obligation arising from the true-up of sales for years one and two would be recognised in profit and loss. Changes in the obligation from the updated forecast in sales in years three to 10 would be recognised as an adjustment to the right-of-use asset. A more detailed example is provided in example 2 in the appendix.

25. The boards considered whether the discount rate should be updated when a remeasurement is required due to a change in estimated term or contingent cash flows; but they concluded that the original incremental borrowing rate should be used as the discount rate throughout the term of the lease. The only exception would be a lease with rentals contingent on variable reference interest rates; for all other leases, the accounting would be consistent with that of a fixed rate borrowing.
PwC observation: The requirements to reassess estimates entails significant incremental effort compared to the current model, under which lease accounting is set at inception and revisited only if there is a modification or extension of the lease. In addition, it may be necessary to invest in information systems that capture and catalogue relevant information and support reassessing lease terms and payment estimates as facts and circumstances change.

Lessee – example

26. The chart below illustrates the affect the proposed standard will have on expense recognition in the income statement in respect of a fixed 10-year lease with escalating rental payments increasing at 2% per year (see also example 1 in the appendix). The current accounting model reflects rent expense on a straight-line basis over the non-cancellable lease term for operating leases. Critics of today’s model have observed that this is sufficiently divergent from the cash due under the contract for it not to reflect economic reality. The new approach is even further from the cash due under the contract.

27. Under the proposed model, rent expense would be replaced with interest and amortisation expense. The expense will be front-end loaded, with more expense recognised at the beginning of the lease term and less at the end — just like a mortgage on the property. For a lease that includes escalating rents, the cash payments will be the inverse of what the expense will be — lower in the earlier years and increasing in the latter years.

28. When a lease contains optional periods or contingent payments, volatility may be introduced into the income statement. A lessee would be required to estimate the lease term and contingent rentals at inception of the lease. Those estimates would need to be adjusted as facts and circumstances change. Using the same lease example as above, the chart below assumes there are two optional five-year renewal periods. The rents under the option periods continue at the same 2% per annum escalation.

29. The chart below depicts the expense recognition pattern in the following scenarios:

- The current leasing model assuming the options were not virtually certain at lease inception — the expense profile has a ‘stair step’ recognition pattern for each non-cancellable term.
- The proposed model assuming management determined at inception that the longest lease term more likely than not to occur was 20 years — this results in increased expense at the front-end of the lease that declines over the lease term.
- The proposed model assuming management initially estimated the longest lease term was 10 years. In year 7, management determined that a 15-year term was likely. Finally, in year 12, management
concluded that the estimated lease term was 20 years — this results in a ‘saw tooth’ expense pattern, adding increased volatility to the income statement.

**PwC observation:** The pattern of expense recognition under the proposed model is not a choice. If and when to include optional periods will depend upon the likelihood of exercising the optional extension periods throughout the lease term. Management should consider all relevant factors in initially determining the lease term and contingent payments and reassess these factors as facts and circumstances change. The estimates will drive whether or when the option periods will be included.

**Lessor accounting**

**The basic models**

30. The boards propose a dual model for lessor accounting. Depending on the economic characteristics of the lease, a lessor would apply either a performance obligation approach or a derecognition approach. The approach used is not a choice for the lessor but depends on whether or not exposure to significant risks and benefits of the leased item are retained.

31. The performance obligation approach would be used for leases where the lessor has retained exposure to significant risks or benefits associated with the leased asset, either during the term or subsequent to the term of the contract, by having the ability or expectation to generate significant returns from or re-leasing the asset. For all other leases, the derecognition approach would be followed.

32. Retaining exposure to the risks or benefits of the leased asset at the end of the term could include either having the expectation or ability to generate significant returns by re-leasing the asset or by selling it. The exposure draft states that a lessor should consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:

- whether there are significant contingent rentals during the lease term that are based on the use or performance of the underlying asset;
- whether there are options to extend to terminate the lease; and
- whether material non-distinct services are provided under the lease.

33. The lessor should also consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the term of the current lease:
• whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset; and
• whether a significant change in the value of the underlying asset at the end of the lease term is expected.

34. The determination of which approach to use would be made at inception of the lease and not revisited.

35. Under the performance obligation approach, the underlying leased asset continues to be accounted for as an economic resource of the lessor and remains on the lessor's balance sheet. The lessor recognises a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset. The performance obligation is satisfied (and revenue recognised) over the lease term. See example 3 in the appendix for an illustration of the accounting under the performance obligation approach.

36. The derecognition approach assumes that the lessor has performed by delivering the leased asset and providing an unconditional right to use it over the lease term. The lessor therefore recognises a receivable, representing the right to receive rental payments from the lessee, and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognised and recorded as cost of sales. See example 4 in the appendix for an illustration of the accounting under the derecognition approach.

PwC observation: The boards made every effort to identify a single lessor accounting model, but it became clear during their deliberations that concerns about the application of each of the two approaches in certain fact patterns could only be addressed through a dual model. For example, board members who expressed general support for the derecognition approach were concerned about applying the approach to short-term leases of long-lived assets or multi-tenant real estate leases. At the same time, board members who expressed general support for the performance obligation approach were concerned about the balance sheet gross-up or supported up-front recognition of manufacturer and dealer profit. The boards recognise that the dual model they are proposing is somewhat similar in concept to existing lessor accounting, but they also noted that, among the numerous alternatives that they considered for determining when to follow one approach or the other, this was the only principles-based alternative.

Initial measurement

37. The lessor's lease receivable would be measured similarly to the lessee's obligation, except that the lessor would be required to use the rate the lessor is charging as the discount rate. The lessor's lease receivable would also include any initial direct costs incurred by the lessor.

38. Under the performance obligation approach, the lease receivable and a performance obligation are recognised. These would be equal, except for the inclusion of initial direct costs in the carrying amount of the former. Under the derecognition approach, two entries would be made: the first recognises revenue and the lease receivable; the second derecognises an allocated portion of the leased asset and presents this as cost of sales. The amount derecognised would be based on the relative fair value of the asset transferred and the residual asset retained.

PwC observation: The exposure draft provides guidance on determining the derecognised portion of the leased asset and the value of the residual asset retained. The amount derecognised by the lessor is calculated as the carrying amount of the underlying asset, multiplied by the fair value of the right to receive lease payments, divided by the fair value of the underlying asset. The derecognised amount is determined at inception of the lease.

Subsequent measurement

39. Subsequent measurement of the lessor's receivable would be at amortised cost using the effective interest method, resulting in interest income.

40. The performance obligation would decrease as the lessor permits the lessee to use the leased item over the lease term. The performance obligation is satisfied and revenue is recognised in a systematic and rational manner based on the pattern of use of the underlying asset (that is, over time, usage or output).
41. **Under the derecognition approach, the lessor would not remeasure the residual asset except for impairment. The residual asset would not be accreted over time.**

**PwC observation:** Similar to the lessee impact, the right-of-use model would affect the timing of income statement recognition for lessors. For the performance obligation approach to lessor accounting, interest income under the effective interest method would be higher in a lease's early years compared to the current straight-line recognition of an operating lease's rental income. For lessors using the derecognition approach, the cost of sales is likely to be different from that currently recognised by manufacturer/dealer lessors, affecting the margin recorded at lease commencement.

In addition, manufacturer/dealer lessors may not qualify for the derecognition approach under the proposal, which would result in lease income being recognised over the term of the lease rather than up-front.

**Lessor consideration of lease term**

42. The boards propose that accounting by lessors for optional renewal periods would generally be symmetrical with the accounting by lessees for those options. However, the boards acknowledge that, in the same lease transaction, the objective of symmetry might not result in the lessee and lessor determining the same lease term, as different judgements might be made based on different perspectives and different information. This is due to the lessee having sole control over the decision to extend and more information about the factors that go into their decision. A lessor might not have insight into the business plans and intentions of the lessee and therefore the renewal options the lessee will exercise. Nonetheless, a lessor is required to estimate the optional periods that the lessee is expected to exercise and revisit the estimate when a change in facts and or circumstances indicates that there would be a significant change in the right to receive lease payments.

**Contingent cash flows**

43. Similarly to lessees, lessors would be required to recognise a receivable for contingent rentals and residual value guarantees, but only if the receivable could be reliably measured. This is consistent with the board's current view in their exposure draft on 'Revenue from contracts with customers', where contingent revenue would be recognised only if the amount can be measured reliably.

**Changes in estimate and remeasurement**

44. Under the performance obligation approach, changes in the lessor's lease receivable resulting from a reassessment of the lease term would be recognised as an adjustment to the performance obligation. In the case of contingent cash flows, changes would be recognised in revenue when the performance obligation has been satisfied. When the performance obligation has yet to be satisfied, changes would be recognised as an adjustment to the carrying amount of the liability.

45. The derecognition approach differs from the performance obligation approach for changes in estimates. When a reassessment results in a change in term, the change in the lease receivable is allocated to the rights derecognised and the residual asset. For changes in contingent cash flows, changes in the lease receivable are adjusted in revenue.

**Other topics**

**Sale and leaseback transactions**

46. Determining whether a linked sale and leaseback transaction would be accounted for as a sale and leaseback (rather than as a financing) would be driven by whether or not the transaction meets the proposed leasing standard's sale criteria – that is, the criteria for an in-substance sale/purchase. The asset would be considered sold when the seller/lessee retains no more than a trivial amount of risks and/or benefits and control is transferred to the buyer/lessor at the end of the lease.
47. If the transaction qualifies as a sale, gains or losses would be recognised immediately. The boards have also proposed that if the sale or leaseback is not established at fair value the asset, liability and gain or loss would be adjusted to reflect current market rentals.

48. If the transaction does not qualify as a sale, it would be accounted for as a financing. The transferred asset would not be derecognised, and any amounts received would be recognised as a financial liability.

PwC observation: IFRS currently requires any gain in a sale and leaseback transaction to be deferred if the subsequent leaseback results in a finance lease. However, if the sale was at fair value, any gain would be taken up front in a sale and leaseback transaction resulting in classification as an operating lease. The determination of operating versus finance lease is based on whether the seller/lessee transfers substantially all of the risks and rewards of the asset. Under the new proposal, more transactions are likely to be treated as a financing rather than a sale due to the higher hurdle of retaining no more than trivial risks and benefits.

Sub-leases

49. As expected, the accounting for subleases builds on the lessee and lessor accounting models that the boards propose. When a leased asset is sub-leased, the sub-lessor would account for the head lease in accordance with the new right-of-use lessee model; it would account for the sub-lease under the appropriate proposed approach for lessor accounting.

50. Presentation of the assets and liabilities will differ depending on which of the two lessor approaches are followed. To avoid the ‘double gross-up’ in the balance sheet that would otherwise result under the performance obligation approach, the boards propose that all assets and liabilities arising from both the head lease and sub-lease, except for the obligation to pay rentals to the head lessor, would be presented together at the gross amounts in the balance sheet with a net subtotal; the obligation to the head lessor would be presented separately in liabilities. However, when the lessor applies the partial derecognition approach, all assets and liabilities arising under a sub-lease would be presented gross in the balance sheet.

Presentation and disclosure

51. For lessee accounting, the boards decided that assets, liabilities, amortisation and interest related to leases would be presented in the financial statements on the basis of the nature of the leased item. The boards also propose that the amounts be broken out on the face of the primary financial statements but have asked respondents to the exposure draft to comment on whether break-out in the footnotes may suffice. Cash repayments of amounts borrowed and interest expense arising from lease contracts would be classified as financing activities separately in the statement of cash flows.

52. Under the performance obligation approach, lessors would present the leased asset, the lease receivable and the performance obligation separately gross in the balance sheet, totalling to a net lease asset or net lease liability. For lessors using the derecognition approach, the residual asset would be separately reported in the balance sheet within property, plant and equipment.

53. The boards differed in their views about the presentation of interest income under the performance obligation approach. The IASB proposes that the amounts be presented separately but does not believe that netting the amounts is necessary; the FASB propose that interest income, lease income and depreciation expense be presented separately in the income statement, totalling to net lease income or expense.

54. Under the derecognition approach, lease income and lease expense would be presented either gross on separate line items or as a single net item depending on the lessor’s business model. If a lessor’s business model uses leases as a means of realising value from goods it would otherwise sell, lease income and expense would be presented as separate line items, often as revenue and cost of sales. If, on the other hand, the lessor’s business model uses leases as a means of providing finance, a single net item would be presented.

55. For lessors, repayments, collections of the lease receivable and interest income arising from that receivable would be presented as operating activities in the statement of cash flows.
56. Due to the significantly expanded use of estimates and judgements in the proposed standard, disclosure requirements will go well beyond those required under current leasing standards. 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.

57. Specific disclosures required would be a description of the nature of an entity’s leasing arrangements, including:

- A general description of those lease arrangements.
- The basis and terms on which contingent rentals are determined
- The existence and terms of options, including for renewal and termination as well as purchase options.
- Information about assumptions and judgements relating to amortisation methods
- The existence and terms of residual value guarantees.
- Initial direct costs incurred during the reporting period and included in the measurement of the right-of-use asset.
- The restrictions imposed by lease arrangements, such as dividends, additional debt and further leasing.

58. The following disclosures would also be required:

- Information about the principal terms of any lease that has not yet commenced if 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: (a) undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years; and (b) 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.

**PwC observation:** The boards generally require disclosure of key estimates and assumptions, often including sensitivity analyses. Because of the increased emphasis on estimates in the model, relative to current standards, it was no surprise that they propose significantly more disclosure.

**Transition and effective date**

59. The boards expect to issue a final standard in mid-2011. The boards have not discussed the effective date of the standard, but presumably it would be no earlier than 2014 to provide management adequate time to prepare for and implement the new standard. The boards plan to seek separate feedback on the effective date because of the number of new standards expected to be issued in 2011. The boards will also consider whether the new standard should permit early adoption.

60. The new standard would be applied by lessees and lessors recognising assets and liabilities for all outstanding leases at the date of initial application (that is, the beginning of the first comparative period presented). As opposed to a full retrospective approach, the boards propose a simplified approach to transition, described below. This simplified approach reflects the reality that, for many long-term leases, the information needed to adopt the new standard retrospectively may no longer be available. The boards considered providing an option to adopt retrospectively, recognising that the asset and obligation are equal only at inception, but rejected that in favour of a single transition approach.

**PwC observation:** The boards propose that the new model be applied as of the date of initial application. Recognition of all outstanding leases would be required on the date of initial application and would be measured at that date. For example, if an entity adopted the standard in its year commencing 1 January 2014 and presented two comparative periods, it would be required to apply the provisions of the standard to its leases as at 1 January 2012. Leases that expired before the year of adoption but existed in the comparative periods (that is, 2012 and 2013 in the example above) would also be included in the balance sheets of those periods.
61. For lessees, the lease obligation would be measured at the present value of the lease payments, discounted using the lessee’s incremental borrowing rate or the rate the lessor charges on the transition date. When lease payments are even over the lease term, the right-of-use asset would be set to equal the transition-date lease obligation. When lease payments are uneven over the term, the accrued or prepaid rent account (used under current standards to provide for straight-line rent expense) will need to be considered as well. Any prepaid rent would be re-characterised as part of the right-of-use asset; accrued rent would be reversed on transition. Additionally, the right-of-use asset will need to be reviewed for impairment in all cases.

PwC observation: Uneven lease payments could include lease incentives, rent-free periods or rent escalation clauses. It is unclear whether the adjustment of the right-of-use asset refers to the amount included on the balance sheet at the date of transition or the contractual amount.

62. The boards also propose an exception for ‘simple finance leases’ – that is, leases currently accounted for as finance leases that do not include any options, contingent rents, term option penalties or residual value guarantees, or options to extend the lease term. The carrying amounts of assets and liabilities under such finance leases at the date of transition would be used as the initial carrying amounts under the new standard.

63. Under the performance obligation approach, lessors would measure the lease receivable and performance obligation using the original rate the lessor is charging the lessee, determined at inception, as the discount rate. A lessor would reinstate previously derecognised leased assets at depreciated cost, adjusted as necessary for any impairment considerations.

64. Under the derecognition approach, lessors would measure the lease receivable at transition using the rate the lessor is charging the lessee, determined at inception of the lease. This is consistent with measurement under the performance obligation approach at transition. The residual asset would be measured at fair value as at the transition date.

PwC observation: The lack of grandfathering for existing leases will require an extensive data-gathering exercise to inventory all contracts and then, for each, capture information about lease term, renewal options, and fixed and contingent payments that is not required by the current lease standards. Gathering and analysing the information could take considerable time and effort, depending on the number of leases, the inception dates and the records available. Beginning the process early will ensure that implementation of the future standard is orderly and well controlled. Management may also want to bear in mind the new model when negotiating lease contracts between now and the effective date of the new standard.

The business impact

Financial ratios and performance measures

65. The proposed model will impact both balance sheet and income statement presentation. The recognition of right-of-use assets will increase lessee’s total assets, resulting in lower asset turnover ratios and usually a lower return on capital employed. In addition, lessee’s current and non-current liabilities will increase, resulting in decreased working capital and an increase in debt to equity ratios. Often right-of-use assets will be presented as non-current assets, while lease obligations will be split into current and non-current elements, thus reducing net current assets.

66. Rent expense will be replaced by depreciation and interest expense. In addition, the expense recognition pattern may change significantly. This will negatively impact some performance measures, such as interest cover, but improve others, such as operating income (EBIT) and EBITDA, with no change in the underlying cash flows or business activity. In addition, periodic remeasurement will increase volatility of key financial ratios.

67. Research completed by PricewaterhouseCoopers and the Rotterdam School of Management in the Netherlands has quantified the minimum impact of the proposed model. Based on the operating lease disclosures in financial statements of some 3,000 companies worldwide, the study concludes that the reported interest-bearing debt of these companies will increase by an average of 58%. This is a cautious estimate, as only the impact of capitalising disclosed operating leases is quantified in the research. Nevertheless, 24% of
the companies will see an increase in their debt balances of over 25%, based on this research. In addition, the companies in the sample will see an average increase in EBITDA of 18%.

68. The research also shows that the impact on financial ratios will differ significantly by industry. For example, the reported debt balances of entities in the retail sector are expected to increase by an average of 213%; leverage (calculated as interest bearing debt divided by equity) will increase by an average of 64%. Approximately 71% of the retail entities will see an increase of reported debt balances of over 25%.

69. The following table includes a summary of the average impact by industry.

<table>
<thead>
<tr>
<th>In % except for leverage</th>
<th>Average increase in interest-bearing debt</th>
<th>% of companies with over 25% increase</th>
<th>Average increase in leverage (percentage points)</th>
<th>Average increase in EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail and trade</td>
<td>213</td>
<td>71</td>
<td>64</td>
<td>55</td>
</tr>
<tr>
<td>Professional services</td>
<td>158</td>
<td>52</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Accommodation</td>
<td>101</td>
<td>41</td>
<td>18</td>
<td>30</td>
</tr>
<tr>
<td>Transportation and Warehousing</td>
<td>95</td>
<td>38</td>
<td>31</td>
<td>44</td>
</tr>
<tr>
<td>Construction</td>
<td>68</td>
<td>20</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td><strong>All companies</strong></td>
<td><strong>58</strong></td>
<td><strong>24</strong></td>
<td><strong>13</strong></td>
<td><strong>18</strong></td>
</tr>
<tr>
<td>Other services</td>
<td>51</td>
<td>35</td>
<td>34</td>
<td>25</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>50</td>
<td>21</td>
<td>9</td>
<td>13</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>34</td>
<td>28</td>
<td>17</td>
<td>21</td>
</tr>
<tr>
<td>Oil, gas and mining</td>
<td>30</td>
<td>16</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Financial services</td>
<td>27</td>
<td>11</td>
<td>6</td>
<td>15</td>
</tr>
<tr>
<td>Amusement</td>
<td>25</td>
<td>18</td>
<td>19</td>
<td>13</td>
</tr>
<tr>
<td>Telecom</td>
<td>23</td>
<td>21</td>
<td>20</td>
<td>16</td>
</tr>
<tr>
<td>Utilities</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>

Contracts with business partners

70. The proposed changes may trigger or even require the re-negotiation of contracts with suppliers, lenders, vendors and employees. Financing agreements with lenders, credit agreements with suppliers and other legal agreements containing financial covenants should be assessed to enable management to discuss potential changes in good time.

71. The impact on financial ratios and performance measures may also require revisions of agreements with third parties to redefine compliance and performance targets.

Human capital

72. Employee compensation arrangements, such as bonuses and share-based payments, based on existing performance measures may need to be modified to be consistent with the spirit of originally expected performance levels. These changes need to be analysed carefully, as they may trigger unwanted modification accounting for compensation agreements.

73. Despite automated solutions for accounting for leases, resource requirements may increase to cope with the increased levels of judgement and documentation. The estimates required for renewal options, contingent rents and residual value guarantees, including periodic re-assessment, may strain an entity’s existing resources. Additional training may also be required to ensure employees understand how to comply with new requirements as well as changed processes and controls.
Accounting systems

74. Lease accounting systems in the marketplace are based on the existing risks and rewards concept; they will need to be modified to the proposed right-of-use concept. Obviously, systems designed to meet entities’ future needs in light of the proposed rules have not yet been created and need to be developed. New systems or upgrades will need to be implemented to ensure entities can capture and report new and additional data or summarise existing data in new ways. Entities will need new IT solutions that can capture data, continuously track individual lease agreements, support the process of developing and reassessing estimates for renewal options and contingent rents for leases, and report certain newly required information and disclosures.

75. Some lessees may look to their lessors to provide them with the necessary input data to comply with the proposed standard. However, lessors may not always have, or may be unwilling to provide, input data required by lessees.

76. Even if input data is provided by lessors, lessees may need to overcome various challenges before they can use the information in their own systems, such as uniformity of input data from different lessors and assurance needs over reliability prior to processing for financial reporting purposes.

Internal controls and processes

77. Many entities in the past have not needed robust processes and controls for leases as existing lessee accounting models (absent a modification or exercise of an extension) did not require leases to be periodically revisited.

78. Initial recording on balance sheet and periodic reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. This will require new or updated documentation of processes and internal controls.

79. Most entities’ financial statements will require restatement for the effect of the changes. Some entities will need to review their financial close-process and design a plan for changes to their chart of accounts and accounting manuals. Entities may also consider whether adjustments for leases will be made locally or at group level depending on their existing and future reporting environments.

Information gathering

80. The proposed model does not permit grandfathering of existing leases. Management will need to catalogue existing leases and gather data about lease terms, renewal options, contingent payments and guarantees to measure the amounts to be included in the balance sheet. If an entity has a significant number of longer-term leases, locating and reviewing agreements that were negotiated decades ago and obtaining the relevant lease documentation could be challenging and time-consuming. Entities with leases in various countries, possibly in different languages, will face different challenges.

81. Gathering and analysing the information could take considerable time and effort, depending on the number of leases, the inception dates and the records available. Beginning the process early would ensure that implementation of a future standard is orderly and well controlled and that data on new leases written before implementation of the changes is captured from the outset. In addition, it may allow entities to consider potential adoption strategies or to renegotiate agreements in order to reduce the impact of adoption.

Tax impact

82. The proposed lease accounting model may have a broad impact on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.

83. Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalisation rules and percentage of EBITDA rules), existing
transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-
border). A reassessment of existing and proposed leasing structures should be performed to ensure continued
tax benefits and management of tax risks.

84. Even where tax does not follow the proposed lease accounting model, management may see an increase in
the challenges of managing and accounting for newly originated temporary differences in the financial statements.

85. Timely assessment and management of the potential tax impact will help optimise the tax position by
enabling entities to seek possible opportunities and/or reduce any tax exposures.

Stakeholder communication

86. The proposed lease rules may impact an entity’s relationship with its business partners such as lenders,
suppliers, lessors, vendors, employees, shareholders and tax authorities. These stakeholders have their own
dynamics and will require a different approach and communication strategy.

87. The investment community is likely to rely on entities to explain the effects on key financial ratios and
performance measures. Timely and clear communication will avoid a weakening in the eyes of these investors,
thus reducing the potential impact on cost of capital.

Timing for comments

89. Comments on the exposure draft are due by 15 December 2010. We encourage management to engage
in the comment letter process and suggest that entities respond formally to the questions included in the
exposure draft.

Additional insights

90. Although the leasing standard is expected to have a pervasive effect, some industries may be more
affected than others due to the types and volume of leases. Future PwC supplements relating to corporate real
estate and equipment leases will address some of the more significant implications to help readers identify
and consider the implications of the proposed standard. Additional supplements may follow.

91. The supplements, examples and related assessments are based on the exposure draft, ‘Leasing,’ which
was issued on 17 August 2010. The provisions of the proposed standard are subject to change at any time
until a final standard is issued. The examples included in the supplements reflect the potential effect of the
proposed standard; any conclusions noted are subject to further interpretation and assessment based on the
final standard.

92. We encourage management to read the topics discussed in the supplements and consider the potential
effects that the proposed standard could have on their existing leasing practices and operations. The issues
discussed in the supplements are intended to assist companies in formulating feedback to the boards, which
could help in the development of a high-quality final standard.

Where to go for more information

93. A summary of all tentative decisions reached by the boards relating to this project can be found on the
IASB website or by clicking here.
Example 1: Simple lessee example

The following example of a real estate lease is provided to demonstrate how the lessee model would be applied in practice. The lease is for a 100,000 square foot building with a 10-year fixed term, an initial annual rent of C20 per square foot (paid in equal monthly increments) with annual escalating payments of 2% per year and an incremental borrowing rate of 7%. The lease has no extension options, residual value guarantees or contingent rent of any kind.

The present value of the cash flows of C15.5 million (calculated as the monthly payments, escalating at 2% per year, with a discount rate of 7%) would be recorded as the lease obligation and the right-to-use asset. The asset would then be amortised, most likely on a straight-line basis, while the obligation is decreased using the effective interest rate method. This results in a total expense of C2.6 million in the first year. This is higher by C612,000 over the cash rent, and C422,000 or approximately 20% higher than what would result under the straight-line method used today.

The example illustrates that over the aggregate term of the lease, the total amount of expense recognised is the same under the proposed model as it is under the current straight-line accounting and is equal to the cash payments.

Balance sheet implications (in C thousands)

<table>
<thead>
<tr>
<th></th>
<th>Initial recognition</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use asset</td>
<td>15,540</td>
<td>13,986</td>
<td>12,432</td>
<td>10,878</td>
<td>9,324</td>
<td>7,770</td>
<td>6,216</td>
<td>4,662</td>
<td>3,108</td>
<td>1,554</td>
<td>0</td>
</tr>
<tr>
<td>Lease obligation</td>
<td>(15,540)</td>
<td>(14,598)</td>
<td>(13,547)</td>
<td>(12,377)</td>
<td>(11,079)</td>
<td>(9,644)</td>
<td>(8,061)</td>
<td>(6,318)</td>
<td>(4,403)</td>
<td>(2,302)</td>
<td>0</td>
</tr>
</tbody>
</table>

Income statement implications (in thousands)

<table>
<thead>
<tr>
<th></th>
<th>Proposed model:</th>
<th>Current accounting model (straight line)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Amortisation of right to use asset</td>
<td>1,554</td>
<td>1,554</td>
</tr>
<tr>
<td>Interest expense on lease obligation</td>
<td>1,058</td>
<td>989</td>
</tr>
<tr>
<td>Total expenses related to lease</td>
<td>A</td>
<td>2,612</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Current accounting model</th>
<th>– Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A- B</td>
<td>422</td>
<td>353</td>
</tr>
<tr>
<td>Difference cumulative</td>
<td>422</td>
<td>775</td>
</tr>
<tr>
<td>Cash (paid in monthly instalments)</td>
<td>2,000</td>
<td>2,040</td>
</tr>
<tr>
<td>Cumulative cash</td>
<td>2,000</td>
<td>4,040</td>
</tr>
</tbody>
</table>
Example 2: Simple lessee example with a change in estimate

The following example illustrates the impact of a change in estimate of lease term. The facts are the same as example 1 above, except that there are two optional five-year renewal periods. The rents under the option periods continue at the same 2% per annum escalation.

At the inception of the lease, management estimated that the longest possible lease term that was more likely than not to occur was 10 years. However, in year 7, management determined that a 15-year term was likely.

At the end of year 7, prior to any adjustment to reflect the change in estimated lease term, the balances reflected in the financial statements were as follows:

| Right-of-use asset | C4,662 |
| Lease obligation   | C6,318 |

At that point, the remaining lease term was adjusted from three years to eight years (reflecting management’s revised view that the longest possible lease term that was more likely than not to occur was increased to 15 years). Although the lease term was now considered to be longer, the discount rate was not adjusted. The present value of lease payments over the remaining eight-year term, discounted at the originally determined incremental borrowing rate of 7%, was C14,957. Hence, the carrying amount of the lease obligation needs to be increased by C8,639. This is recognised as an adjustment to the right-of-use asset, as follows:

| Dr     | Right-of-use asset | C8,639 |
| Cr     | Lease obligation   | C8,639 |

A consequence of this adjustment is that the total amortisation and interest expense in year 8 will increase from C1,936 to C2,668.
Example 3: Simple lessor example – performance obligation approach

The following example of a real estate lease demonstrates how the performance obligation under lessor accounting would be applied in practice. The lease is for a 100,000 square foot building with a 10-year fixed term, an initial annual rent of C25 per square foot (paid in equal monthly increments) with annual escalating payments of 2% per year and an incremental borrowing rate of 7%. Of the initial C25 per square foot amount, C5 of the payment is related to common area maintenance charges. The lease has no other residual value guarantees or contingent rent of any kind. The carrying value of the underlying asset at lease commencement is C20 million and has a remaining useful life of 40 years.

The present value of the cash flows of C15.5 million (calculated as the initial C20 monthly payments, escalating at 2% per year, with a discount rate of 7%) would be recorded as the lease receivable and the performance obligation. The lease asset would then be decreased using the interest method; the performance obligation is decreased based on the pattern of use of the underlying asset, most likely on a straight-line basis; and the underlying asset is depreciated on a straight-line basis using the remaining life of 40 years. This results in net lease income of C2,112,000 in the first year. This is higher by C422,000 or approximately 25% than would result under the straight-line method used today.

### Balance sheet implications (in C thousands)

<table>
<thead>
<tr>
<th>At inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>15,540</td>
<td>14,598</td>
<td>13,547</td>
<td>12,377</td>
<td>11,079</td>
<td>9,644</td>
<td>8,061</td>
<td>6,318</td>
<td>4,403</td>
<td>2,302</td>
</tr>
<tr>
<td>Underlying asset</td>
<td>20,000</td>
<td>19,500</td>
<td>19,000</td>
<td>18,500</td>
<td>18,000</td>
<td>17,500</td>
<td>17,000</td>
<td>16,500</td>
<td>16,000</td>
<td>15,500</td>
</tr>
<tr>
<td>Performance obligation</td>
<td>(15,540)</td>
<td>(13,986)</td>
<td>(12,432)</td>
<td>(10,878)</td>
<td>(9,324)</td>
<td>(7,770)</td>
<td>(6,216)</td>
<td>(4,662)</td>
<td>(3,108)</td>
<td>(1,554)</td>
</tr>
</tbody>
</table>

### Income statement implications (in C thousands)

#### Proposed model:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income on lease receivable</td>
<td>1,058</td>
<td>989</td>
<td>911</td>
<td>825</td>
<td>730</td>
<td>625</td>
<td>509</td>
<td>382</td>
<td>242</td>
<td>89</td>
</tr>
<tr>
<td>Lease income on perf obligation</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
<td>1,554</td>
</tr>
<tr>
<td>Subtotal of lease revenue</td>
<td>2,612</td>
<td>2,543</td>
<td>2,465</td>
<td>2,379</td>
<td>2,284</td>
<td>2,179</td>
<td>2,063</td>
<td>1,936</td>
<td>1,796</td>
<td>1,643</td>
</tr>
<tr>
<td>Depreciation of underlying asset</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Total net lease income</td>
<td>A</td>
<td>2,112</td>
<td>2,043</td>
<td>1,965</td>
<td>1,879</td>
<td>1,784</td>
<td>1,679</td>
<td>1,563</td>
<td>1,436</td>
<td>1,296</td>
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</table>

#### Current accounting model:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease income (straight-line)</td>
<td>2,190</td>
<td>2,190</td>
<td>2,190</td>
<td>2,190</td>
<td>2,190</td>
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<td>2,190</td>
<td>2,190</td>
<td>2,190</td>
<td>2,190</td>
</tr>
<tr>
<td>Depreciation of asset</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Total net lease income</td>
<td>B</td>
<td>1,690</td>
<td>1,690</td>
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<td>1,690</td>
<td>1,690</td>
<td>1,690</td>
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</table>

#### Difference - current period

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Difference - current period</td>
<td>A - B</td>
<td>422</td>
<td>353</td>
<td>275</td>
<td>189</td>
<td>94</td>
<td>(11)</td>
<td>(127)</td>
<td>(254)</td>
<td>(394)</td>
</tr>
<tr>
<td>Difference cumulative</td>
<td>422</td>
<td>775</td>
<td>1,050</td>
<td>1,239</td>
<td>1,333</td>
<td>1,322</td>
<td>1,315</td>
<td>1,307</td>
<td>1,299</td>
<td>1,291</td>
</tr>
<tr>
<td>Cash (paid in monthly instalments)</td>
<td>2,000</td>
<td>2,040</td>
<td>2,081</td>
<td>2,123</td>
<td>2,165</td>
<td>2,208</td>
<td>2,252</td>
<td>2,297</td>
<td>2,343</td>
<td>2,391</td>
</tr>
<tr>
<td>Cumulative cash</td>
<td>2,000</td>
<td>4,040</td>
<td>6,121</td>
<td>8,244</td>
<td>10,409</td>
<td>12,617</td>
<td>14,869</td>
<td>17,166</td>
<td>19,509</td>
<td>21,900</td>
</tr>
</tbody>
</table>
Example 4: Simple lessor example – derecognition approach

The following example of an equipment lease demonstrates how the journal entries under the derecognition approach would be calculated for both equipment in inventory (carrying value is not equal to the fair value) and equipment whose carrying value is equal to the fair value. The lease is for a piece of equipment with the following contract terms and assumptions:

<table>
<thead>
<tr>
<th>Example lease term and assumptions</th>
<th>Carrying value not equal to fair value</th>
<th>Carrying value equals fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of asset</td>
<td>C100,000</td>
<td>C100,000</td>
</tr>
<tr>
<td>Cost of asset</td>
<td>C60,000</td>
<td>C100,000</td>
</tr>
<tr>
<td>Monthly lease payments</td>
<td>C2,763</td>
<td>C2,763</td>
</tr>
<tr>
<td>Lease term</td>
<td>3 Years</td>
<td>3 Years</td>
</tr>
<tr>
<td>Rate charged in the lease</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Estimated residual value at lease end</td>
<td>C11,000</td>
<td>C11,000</td>
</tr>
</tbody>
</table>

Based on the assumptions above, the lease receivable and corresponding lease revenue of C90,823 is calculated by taking the present value of monthly cash payments of C2,763 discounted at a 6% rate. The amount of the asset derecognised, and corresponding cost of goods sold of C54,494, and C90,823 is calculated by taking the carrying value of the asset multiplied by the present value of lease payments and then divided by the fair value of the asset (C60,000*C90,823/C100,000) and (C100,000*C90,823/C100,000). The lease asset would subsequently be decreased using the interest method. The underlying asset remains unchanged during the lease term, unless an impairment adjustment is necessary.

<table>
<thead>
<tr>
<th>Journal entries at lease commencement:</th>
<th>Carrying value not equal to fair value</th>
<th>Carrying value equals fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Lease receivable</td>
<td>C90,823</td>
<td>C90,823</td>
</tr>
<tr>
<td>Lease revenue/income</td>
<td></td>
<td>C90,823</td>
</tr>
<tr>
<td>Lease expense</td>
<td>C54,494</td>
<td>C90,823</td>
</tr>
<tr>
<td>Residual asset</td>
<td>C5,506</td>
<td>C9,177</td>
</tr>
</tbody>
</table>