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A Deeper Dive into IFRS

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Today's Presenters

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Agenda for Today

Brief update on IFRS

Property, Plant and Equipment

Intangible Assets

Impairment

Leases

Brief update on IFRS

IFRS background

IFRS — Background

- **International Financial Reporting Standards (IFRS) —** A comprehensive, globally accepted set of accounting standards
  - When compared to U.S. GAAP, more of a principles-based approach, with greater emphasis on interpretation and the use of judgment, and less reliance on "bright-line rules"
- **Global use —** Used in over 100 countries by more than 40% of the Global Fortune 500
  - **Current**: European Union (EU) countries, Hong Kong, Australia, and many Middle East and South American countries
  - **Future:** Brazil (2010); Canada, India, and South Korea (2011); Mexico (2012); Japan early adopters (2010); Japan mandatory (2015)
  - **Proposed:** U.S. early adopters (2009), U.S. mandatory (2014-2016),

What are companies saying?[1]

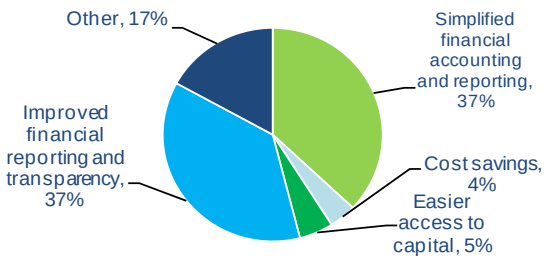

Figure 1. Perceived benefits to adopting IFRS, from respondents that would consider adopting IFRS before 2014

42% indicated that, if permitted, they would consider implementing IFRS sooner than 2014 (the initial mandatory date within the SEC proposed roadmap)

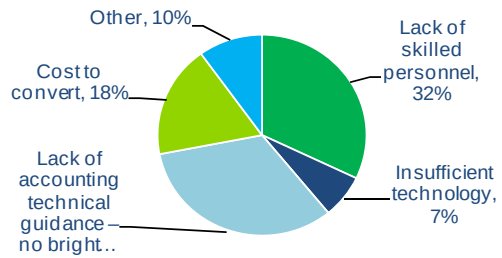

Figure 2. Perceived challenges of adopting IFRS, from respondents that would consider adopting IFRS before 2014

[1] **Source: November 2008 Deloitte* survey of over 200 respondents**

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Regulatory developments in the U.S.

U.S. developments

- **December 2007**
  - Foreign private issuers can file under IFRS without a reconciliation to U.S. GAAP
- **November 2008**
  - SEC issues proposed roadmap and rule changes (mandatory adoption beginning 12/31/14)
  - The G-20 adopted, as a medium-term priority, the implementation of a globally consistent set of accounting standards
- **April 2009**
  - At the inaugural meeting of the International Accounting Standards Committee Foundation (IASCF) Monitoring Board, SEC Chairman, Mary Schapiro, reiterates her support for a single set of global standards
    - Comment period on the proposed roadmap ended April 20, 2009
- **September 2009**
  - On September 14, SEC Chief Accountant, James Kroeker stated at an AICPA conference, "Convergence of accounting standards and the proposed roadmap will be a priority for us in the weeks and months to follow"
  - Mr. Kroeker also stated that some individuals may have read into the roadmap's extension as a sign that the agency "lacked interest" in IFRS. He also stated, "I wouldn't read anything into the extension."
- **Future expected developments**
  - It is expected that the G-20 will make strong statements toward a global set of accounting standards in its upcoming September 2009 meeting

Property, Plant & Equipment

PP&E summary

- Overview & scope
- Elements of initial cost
- Borrowing costs
- Revaluation model
- Componentization
- Depreciation
- Residual value
- Major inspections and overhauls
- Key accounting differences
- Disclosure considerations
- Other PP&E considerations
- Biological assets (IAS 41)
- Example

PP&E: Overview & Scope

Scope

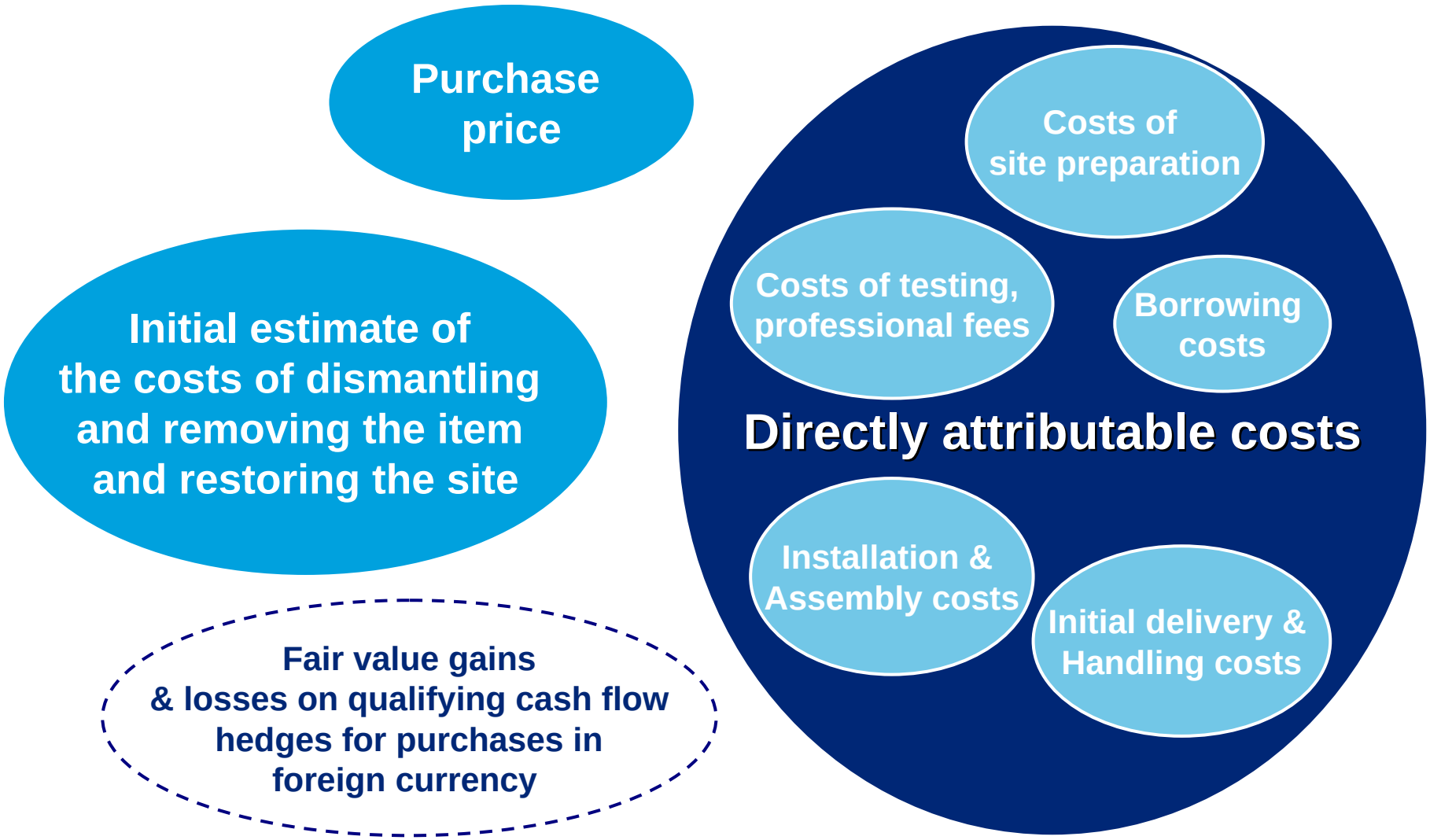
- Applies in accounting for PP&E except where another standard requires/permits a different accounting treatment (e.g. IAS 17)
- Does not apply to assets held for sale (IFRS 5); biological assets related to agricultural activities (IAS 41), exploration assets (IFRS 6), however it does apply to PP&E used to develop or maintain these assets

Definition

- PP&E are tangible assets that:
  - Are held for use in production or supply of goods or services for rental to others, or for administrative purposes; and
  - Are expected to be used during more than one period

PP&E is initially measured at cost but there are two valuation models for subsequent measurement – cost and revaluation model

PP&E: Elements of initial cost



PP&E: Borrowing Costs

Core principle of IAS 23 (Revised and effective January 1, 2009)

- Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset
- Other borrowing costs are recognized as an expense
- However, similar to US GAAP, IAS 23 does not require capitalization for qualifying assets measured at fair value or inventories manufactured/produced in large quantities on a repetitive basis

➢ **Previous version of IAS 23 provided for an accounting policy choice between capitalization and expensing**

➢ **A difference from U.S. GAAP may continue to exist as retrospective capitalization is not required**

Definition of borrowing costs

- Broader definition than SFAS 34 [ASC 835]
- May include:

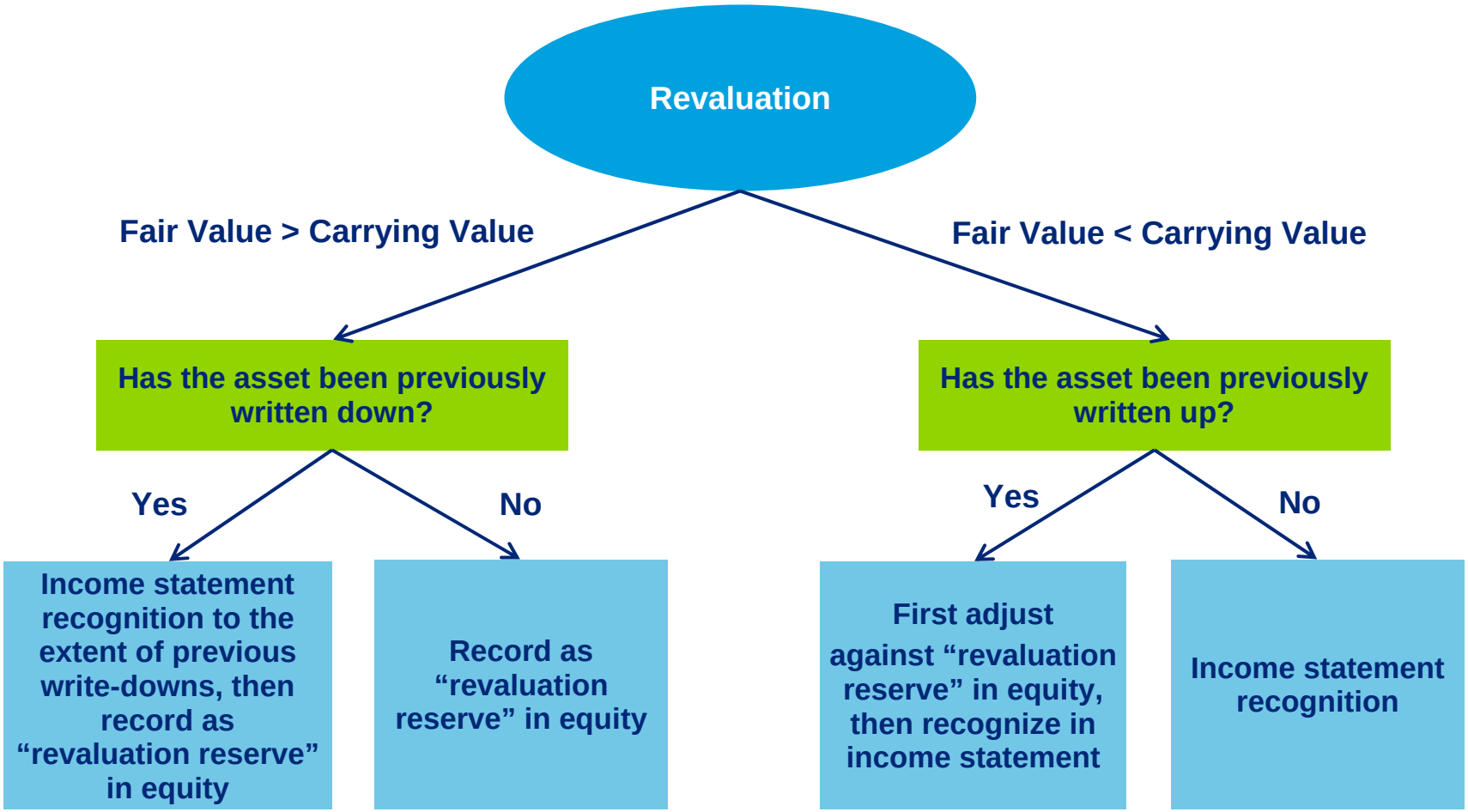
– Interest expense calculated using the effective interest method under IAS 39

– Finance charges in respect of finance leases

– Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

PP&E: Revaluation model

- If opted, the revaluation model must be applied to all assets within the same class.
- Most entities in Europe did not opt for this model on initial adoption of IFRS



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PP&E: Componentization

IFRS Requirement	Potential Approach	Potential Impact
• Each part of an item of property, plant and equipment should be depreciated separately.	• For each part of an item of property, plant and equipment, assess whether it should be separated into its significant parts (i.e. components) • Consider its cost • Need to allocate the cost and determine the useful life of each of the components for depreciation purposes • Determine if current systems applications can perform calculations or if a new application is required • Change in SOPs/desk instructions around PP&E	• More detailed depreciation calculation • May result in higher or lower depreciation expense, depending on the life of the individual components • Any changes in an asset's components would effect depreciation and be disclosed as a change in estimate

PP&E: Depreciation

Depreciation method

- Shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity
  - Examples: straight-line method, diminishing balance method, units of production method
  - Depreciable amount = cost – residual value
  - No further depreciation if residual value > carrying amount

Useful life

- Period over which an asset is expected to be available for use by an entity; or
- Number of production or similar units expected to be obtained from the asset by an entity

➢ **May differ from the "economic life"**

Residual value

- Estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Depreciation method, useful life and residual value reviewed at least at each financial year-end

PP&E: Residual Value

Measurement

- Current selling price assuming asset already of age and condition expected at the end of its useful life
- ➢ **U.S. GAAP requires the present value of expected proceeds on future disposal**

Reviewed at least each financial year-end

- Adjusted upwards or downwards
- ➢ **Only downwards for U.S. GAAP purposes**
- ➢ **Potential for more volatility under IFRS**

PP&E: Major inspections & overhauls

- Separate component upon initial recognition if recognition criteria are met
- Subsequently, costs are capitalized as a replacement component if recognition criteria are met (future benefits and measurement reliability)
- Remaining carrying amount of the replaced asset (the inspection component) to write off
- Estimated cost of future similar inspections can be used as an approximation for the cost of existing inspection components if not previously identified

➢ **Under U.S. GAAP, FSP AUG AIR-1 [ASC 908-360] provides the following three methods:**

1. **Expensed as incurred**
2. **Deferred and amortized over the period until the next overhaul**
3. **Accounted for as part of the cost of the asset**

PP&E: Key accounting differences

U.S. GAAP

- Components approach is permitted, but, in our experience, is generally not used
- Revaluation is prohibited
- Costs related to major inspection or overhaul may be expensed, capitalized into the cost of PP&E, or deferred and amortized (over the period until the next overhaul)
- Residual value of an item of PP&E is the discounted present value of expected proceeds on it's future disposal. Residual value may only be adjusted downwards. No requirement for an annual review of residual values

IFRS

- Component approach when PP&E can be separated into its significant parts/ components is required
- Revaluation is permitted subsequent to initial recognition, only if the fair value of classes of PP&E can be measured reliably
- Capitalization of major maintenance and overhaul into cost of PP&E (in general)
- Residual value of an item of PP&E is it's current net selling price assuming the asset is already of the age and in the condition expected at the end of its useful life. Residual value may be adjusted upwards or downwards. Review of residual values (at least annually) is required

PP&E: Disclosure considerations

- Reconciliation of the carrying amount at the beginning and end of the period showing:
  - Additions to PP&E
  - Assets classified as held for sale
  - Acquisitions through business combinations
  - Increase or decreases resulting from revaluations
  - Impairment losses (including reversals)
  - Depreciation
  - The net exchange differences on PP&E balances arising on the translation of the financial statements
- The amounts of expenditures recognized in the carrying amount of an item of PP&E in the course of its construction

PP&E: Other considerations

First Time Adoption

- Consider election to use fair value as deemed cost at transition date
- Determine components of assets
- Assess depreciation methods for consistency with IFRS

Accounting Policies and Internal Controls

- Ensure consistency of judgments throughout organization (e.g. componentization, residual values)
- Document basis for judgments/estimates (adequacy of audit trail)

Income Taxes

- Differences in the basis of long-lived assets and associated depreciation will cause deferred tax differences
- Componentization and revaluation may pose specific challenges for calculating book tax differences

People

- Increased judgment – e.g. Residual values, depreciable lives for individual components
- Additional time requirements – e.g. Review of residual values, componentization and tracking of new assets

Information Systems

- Additional functionality may be required – e.g. separately track and depreciate components, change residual values

Biological Assets (IAS 41)

IFRS	U.S. GAAP
• Under IFRS, biological assets (i.e. living trees) are measured at their fair value, less estimated point-of-sale costs. • Point of sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges and transfer taxes and duties. Point-of-sale costs exclude transport and other costs necessary to get assets to a market • Any change in the fair value of biological assets during a period is reported in income statement.	▪ Under U.S. GAAP, forest assets are measured at cost less depletions. ▪ Cost includes all expenditures on acquisition of forests plus reforestation and forestry development costs.

PP&E: Example

- Star Transport Limited (“Star”) is a leading ocean carrier. Star offers its customers worldwide container transportation service with more than 600 vessels and 2 million containers.

- On January 1, Star purchased a vessel for $65 million. The vessel has a useful life of 20 years but will be required to undergo a dry dock overhaul every five years to restore its service potential. The estimated cost for each overhaul is $8 million.

- Star also has an obligation to scrap the vessel at the end of its useful life. The present value of the cost of scrapping the vessel is $5 million.

- Star uses the cost model and the straight line depreciation method to measure the vessel. No other components have been identified for the vessel.

Examples for illustrative purposes only

Question #1

Determine the carrying amount of the vessel upon initial recognition on January 1.

- The carrying amount of the vessel upon initial recognition is $70 million.

- The carrying amount includes the purchase price ($65 million) and the obligation to scrap the vessel at the end of its useful life ($5 million).

- The purchase price of a new vessel already includes the cost of the overhaul component such that Star would be double counting that cost if it were added to the carrying amount of the vessel. at the time of initial recognition.

Examples for illustrative purposes only

Question #2

Determine the depreciation charge for year 1.

The amount of depreciation charge would be $ 4.7 million, determined as follows:

Carrying Amount of Vessel	*Amount ($ millions)*	*Useful life (years)*
Purchase price of vessel	65	
Comprising:		
Vessel, excluding overhaul	57	20
Overhaul	8	5
Asset retirement costs (scrapping vessel)	5	20
	70	
For years 1 to 5, annual depreciation expense is:		
Asset retirement costs	0.25	
Vessel, excluding overhaul	2.85	
Overhaul component	+ 1.60	
	4.70	

Examples for illustrative purposes only

Question #3

At the end of year 3, Star has reassessed the need for an overhaul for the vessel and incurred a cost of $8 million. Determine the potential accounting consequences of implementing the overhaul at the end of year 3 instead of year 5 as originally planned.

Star should derecognize the carrying amount of the old overhaul at the same time as the expenditure on the new overhaul is capitalized.

Derecognition of the old overhaul:

Gross carrying value	8.0
Accumulated depreciation	- 4.8 (1.6 x 3 years)
	3.2

Recognition of the new overhaul cost component is $8 million.

Examples for illustrative purposes only

Intangible Assets

Intangible assets summary

- Overview
- Scope
- Capitalization of development costs
- R&D costs
- Types of intangibles
- Key accounting differences
- Other considerations

Intangible assets: Overview

Addresses accounting for intangible assets acquired separately or in a business combination, and those internally generated.

Intangibles are recognized if they are:

- Controlled by the entity
- Expected to generate future economic benefits
- “Identifiable”
  - Separable (can be divided and sold, transferred, licensed, rented or exchanged), or
  - Contractual or legal right
- Reliably measurable

Must classify internally generated intangibles into a research phase and a development phase.

- Research expenditures are expensed;
- Development expenditures are capitalized, if certain criteria are met

Intangibles may be revalued, if certain criteria are met

Intangible assets: Scope

Intangibles are identifiable, non-monetary assets without physical substance

- Examples include software, patents, customer lists, etc.

IAS 38 applies to all intangibles other than:

- Financial assets (IAS 32)
- Mineral rights and exploration and development costs incurred by mining and oil and gas companies (IFRS 6)
- Intangibles arising from insurance contracts issued by insurance companies (IFRS 4)
- Intangibles covered by another standard such as intangibles held for sale (IAS 2), deferred tax assets (IAS 12), lease assets (IAS 17), assets arising from employee benefits (IAS 19), and goodwill (IFRS 3).

Intangible assets: Capitalization of development costs

Ability to demonstrate the following criteria

- Technical feasibility
- Intention to complete the intangible asset and use or sell it
- Ability to use or sell the intangible asset
- How the intangible will generate probable future economic benefits
- Availability of adequate technical, financial and other resources to complete the development
- Ability to reliably measure the expenditure during development

Costs capitalized from date criteria are met

- Directly attributable to asset

Intangible assets: Research and development costs

Subject	U.S. GAAP criteria	IFRS criteria
R&D costs	Expensed as incurred SFAS 2 (Para 12)	• Costs incurred are tested to ascertain if they meet the definition of an intangible asset • Costs are segregated in to research and development phases • Any costs incurred during research phase are expensed as they incur – e.g. activities to obtain new knowledge, search for alternate materials, evaluating and making selection of alternatives, etc. • Costs incurred during the development phase are capitalized if certain criteria are met – • Examples of development include designing, constructing, testing of prototype, etc. (Criteria includes technological feasibility, intention to complete the asset, ability to use/ sell, ability to reliably measure the expenditures, availability of resources to complete the development, and that the asset will generate probable future economic benefits)
Acquired IPR&D costs	Capitalized at FV if there is an alternative future use – SFAS 141R	An acquirer recognizes an IPR&D asset if the project "meets the definition of an intangible asset and its fair value can be measured reliably“ IFRS 3 (Para 45)

Intangible assets: Types of intangibles

Type	U.S. GAAP	IFRS
Computer software for sale or lease	Expensed until "technological feasibility" is established and capitalized thereafter *Literature – FAS 86*	Capitalized, if certain criteria are met
Computer software for internal use	Expensed or capitalized depending upon the nature and stage of development *Literature – SOP 98-1*	Capitalized, if certain criteria are met
Web-site development costs	Expensed or capitalized depending upon the stage of development *Literature – EITF 00-2*	Expensed or capitalized depending upon the stage of development *Literature – SIC 32*
Advertisement costs	Expensed as incurred or first time advertisement takes place Direct response advertisement cost is capitalized *Literature – SOP 93-7*	Expensed as incurred

Intangible assets: Key accounting differences

U.S. GAAP

•Research and development costs are typically expensed as incurred

IFRS

- Certain direct *development* costs are capitalized upon achievement of technical and economic feasibility. Among other things, the company must be able to demonstrate
  - Intention and ability to complete and use or sell the asset
    - Technical feasibility
    - Adequate technical and financial resources
  - Probable future economic benefits
    - Market for the asset or its output, or
    - Usefulness of an asset for internal use
- The definition of development under IFRS is similar to U.S. GAAP
  - Application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use;
    - Includes design, construction and testing of prototypes, tooling, a chosen product alternative, and operation of a pilot plant
  - Development costs are distinguished from research costs and start-up costs, which are expensed as incurred

Intangible assets: Other considerations

First Time Adoption

- Identification and capitalization of historical development costs

Accounting Policies and Internal Controls

- Ensure consistency of judgments throughout organization
- Document basis for judgments/estimates (adequacy of audit trail)

Income Taxes

- Capitalization of development costs may result in deferred tax balance
- The computation of the research and development tax credit will continue to include the expenditures in the year they are incurred, irrespective of the book treatment
- Mechanics of calculating the credit will change as some expenditures will now be on the balance sheet

People

- Organization wide training and communication

Information Systems

- Additional projects to break out cost between research and development
- Amortization of capitalized development costs

Impairment

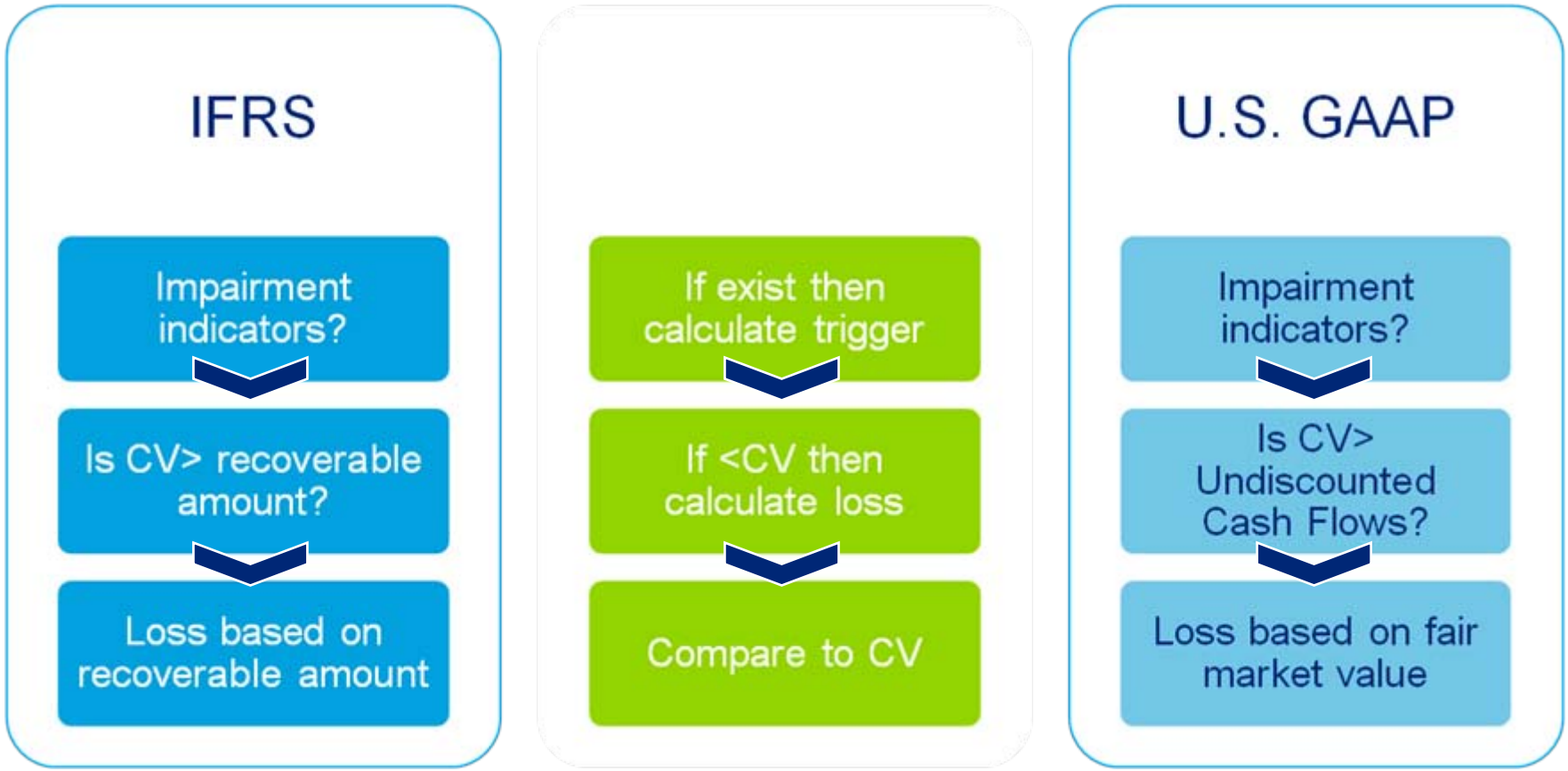
Impairment summary

- Overview
- Asset impairment approach
- Recoverable amount
- Case study: calculating asset impairment
- Goodwill allocation and testing
- Goodwill impairment approach
- Example: calculating goodwill impairment
- Reversal of impairment losses
- Key accounting differences
- Disclosure considerations

Impairment: Overview

- Primary standard – IAS 36
- A single approach to impairment
- Focus on the asset's "recoverable amount" which is the higher of fair value less costs to sell and value in use (VIU)
- VIU is the present value of estimated future cash flows expected to arise from use of the asset and its disposal
- Level of testing is based on the "cash generating unit" (CGU) (i.e., smallest identifiable group of assets that generates cash flows independent of other assets)
- For goodwill testing may aggregate CGUs; must at least allocate to an operating segment
- Impairment charges (except on goodwill) are required to be reversed, if certain criteria are met

Impairment: Asset impairment approach



Impairment: Recoverable amount

- Recoverable amount is the higher of:
  - Fair value less costs to sell- amount obtainable from the sale of asset in arm's length transaction less costs of disposal)
  - Value in use (i.e., the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal)
- Will not be the same as U.S. GAAP "trigger"
- May not be the same as fair value, which is a "market value" notion

Example: Asset impairment

Asset carrying amount	100
Value in use	90
Fair value less costs to sell	80
Fair market value	85
Undiscounted cash flows	110

What is the impairment charge under U.S. GAAP and under IFRS?

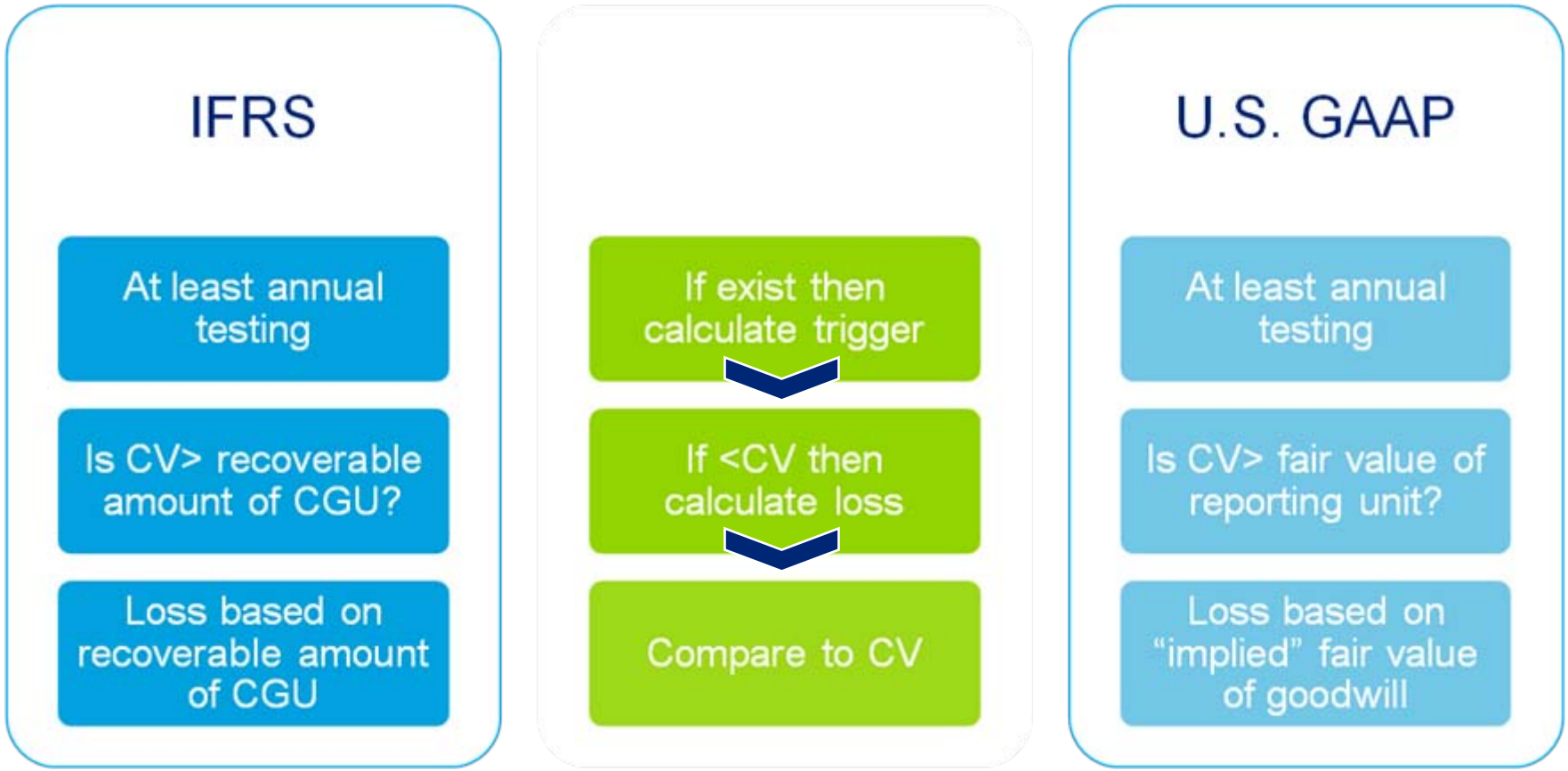
Answer – No impairment under U.S. GAAP and impairment charge of 10 under IFRS

Examples for illustrative purposes only

Impairment: Goodwill allocation and testing

- Basic principle
  - Goodwill is allocated to the acquirer's CGU (or group of CGUs) that are expected to benefit from the synergies of the business combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units
- For goodwill testing, look at how management allocated goodwill
- Under IFRS, management may end up testing goodwill at a lower level of the organization than under U.S. GAAP
- Single step impairment test under IFRS
- Under IFRS, CGUs are tested for impairment by comparing the carrying amount (including goodwill) with its recoverable amount and any impairment loss is recognized.

Impairment: Goodwill impairment approach



Example: Goodwill impairment

Potential differences	Carrying amount	Fair value
Cash	150	150
Accounts receivable	300	300
Equipment	350	350
Land	350	200
Goodwill	50	0
Liabilities	200	200

- **Prior to performing this goodwill impairment test, no individual asset was triggered for impairment**
- **Calculate the impairment loss under IFRS if the recoverable amount is 900 and under U.S. GAAP if the FV of the reporting unit is 900**

Examples for illustrative purposes only

Goodwill impairment: U.S. GAAP

What is the impairment charge under U.S. GAAP?

Asset	Carrying amount	Fair value
Cash	150	150
Accounts receivable	300	300
Equipment	350	350
Land	350	200
Goodwill	50	0
Liabilities	200	200
Net assets	1,000	800
Fair value of reporting unit	N/A	900
Implied FV of goodwill	N/A	100

Impairment loss: 0 (100>50)

Examples for illustrative purposes only

Goodwill impairment: IFRS

What is the impairment charge under IFRS?

Asset	Carrying amount	Allocation of impairment loss
Cash	150	0
Accounts receivable	300	0
Equipment	350	**50**
Land	350	
Goodwill	50	50
Liabilities	200	N/A
Net assets	1,000	N/A
Recoverable amount	900	N/A

Impairment loss: 100

Examples for illustrative purposes only

Reversal of impairment losses

- At each reporting date, assess if there could be external and internal indications that previously recognized impairment may no longer be valid for assets other than goodwill
- If any indication exists, estimate the recoverable amount of that asset
- If recoverable amount is now higher than the carrying amount = impairment no longer exists
- Reverse the loss by increasing the carrying amount (for assets in CGU on pro-rata basis) only up to the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset in prior years
- Reverse if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized
  - Not just due to passage of time
- Reversal of impairment for goodwill is prohibited

Impairment: Key accounting differences

- Impairment charges may be recognized in an earlier period given differences in the impairment “trigger”
- The level of impairment testing may be different depending on the CGU
- Amount of impairment may be different based on the recoverable amount of the asset
- Any impairment charges on property, plant, and equipment, and intangibles (except goodwill) are required by IFRS to be reversed, if certain criteria are met

Impairment: Disclosure considerations

Disclosure by class of assets: [IAS 36.126]

- Impairment losses recognized in the income statement
- Impairment losses reversed in the income statement
- Which line item(s) of the income statement

Disclosure by segment: [IAS 36.129]

- Primary segments only (usually product line or industry)
- Impairment losses recognized
- Impairment losses reversed

Other disclosures: [IAS 36.130, 131, 134-35]

- Disclosure when individual impairment loss is material
- Disclose detailed information about the estimates used to measure recoverable amounts of cash generating units containing goodwill or intangible assets with indefinite useful lives.

Leases

Leases summary

- Overview
- Scope
- Lease classification (indicators, approach)
- Example
- Leases with land and buildings
- Sale/leaseback transactions
- Disclosure considerations - Lessees
- Disclosure considerations – Lessors
- Key accounting differences
- Other lease considerations

Leases: Overview

- Addresses accounting for lessees & lessors
- Leases accounted for based on classification; operating leases are “off balance sheet”, finance leases are “on balance sheet”
- Leases of land and buildings are required to be accounted for separately, if material
- Sale/leasebacks are accounted for based on their substance
- Operating leases are recognized on a straight-line basis

Leases: Scope

Leases convey in return for a payment the right to use an asset for a period of time

- May be an intangible

IAS 17 applies to all leases other than:

- Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources
- Licensing agreements (IAS 38)
- Investment property (IAS 40)
- Biological assets (IAS 41)

Service concession arrangements are within the scope of IFRIC 12

Lease Classification

Under IAS 17:

- A lease is classified as a finance lease if it transfers “substantially all the risks and rewards incidental to ownership”
- A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract

Leases: Classification indicators

Indicator	IFRS	US GAAP
Ownership is transferred to lessee at end of lease term	Finance lease indicator	Capital lease
Bargain purchase option exists	Finance lease indicator	Capital lease
Lease term is for majority of asset's economic life	Finance lease indicator	Capital lease if =/> 75% of asset's economic life
PV of minimum lease payments (MLP)= substantively all of the FV of the leased asset	Finance lease indicator	Capital lease if =/> 90% of fair value of asset
Leased assets are specialised in nature-only lessee can use them without major modification	Finance lease indicator	Not specified
Other indicators that could lead to finance lease	Lessor's losses borne by lessee on cancellation Gains and losses from the fluctuation in FV of residual fall to the lessee Lessee has ability to continue the lease for a secondary period at below market rentals	Not specified

Approach to Lease Classification

IFRS Requirement	Approach	Impact

Classify leases under IFRS as either operating or finance based on circumstances existing at lease inception	• Detailed rules and "bright-line" criteria are not provided in IFRS
	  • Establish "benchmarks" for analysis
	  • More of a holistic approach versus a "compliance" exercise
	  • The reasons for the arrangement and nature of the leased assets
	  • Lease term and renewal or purchase options
	  • Residual effects and cancellation
	  • Guarantees
	  • Minimum lease payments
		Potentially more leases on balance sheet (i.e., finance leases)

Leases: Example

- Beginning of the lease term does not fall within the last 25 percent of the total estimated economic life of the leased property.
- Present value of the minimum lease payments, at the beginning of the lease term is $890.
- Fair value of the leased property is $1,000.

How will you classify the above lease transaction under IFRS and US GAAP?

Examples for illustrative purposes only

Solution

How will you classify the above lease transaction under IFRS and US GAAP?

Under IFRS, it may be classified as a finance lease while under US GAAP it is an operating lease because the present value of minimum lease payment does not meet the threshold criteria of 90% of the fair value of leased asset.

Examples for illustrative purposes only

Leases involving Land and Buildings

Land and building elements are considered separately for lease classifications, if material

- Often results in classification of land component as operating lease

Complex accounting under U.S. GAAP, but building and land generally considered a single unit, except when:

- Fair value of the land is more than 25% of the total fair value
- Ownership transfers at the end of the lease or bargain purchase option

Sales and Leaseback Transactions

Before evaluating the leaseback, the transaction must be in effect a “normal sale”

- No similar requirements as set out in FAS 66 and FAS 98

Treatment of any profit or loss depends on the classification of lease

- If resulting in an operating lease, look to whether the property is sold at, above or below fair value
  - Record in income if sold at or below fair value (unless below market lease)
  - Defer and amortize if sold above fair value
- If resulting in a finance lease, amortize any excess of sales proceeds over the carrying amount over the lease term

Disclosures – Lessees

Finance Leases	Operating Leases
• Net carrying amount for each class of asset • Description of significant leasing arrangements • Analysis of commitments under non-cancellable leases by period • Reconciliation between future minimum lease payments and their PV • Contingent rents recognized as an expense • Future minimum sublease payments expected to be received under non-cancellable subleases	• Description of significant leasing arrangement • Analysis of commitments under non-cancellable operating leases by period • Future minimum sublease payments expected to be received under non-cancellable subleases • Analysis of lease and sublease payments recognized as an expense

Disclosures – Lessors

Finance Leases	Operating Leases
• Description of significant leasing arrangements • Reconciliation between gross investment in the lease and the PV of minimum lease payments receivable • Analysis of commitments under non-cancellable leases by period • Contingent rents recognized as an income • Unearned finance income • Unguaranteed residual values • Accumulated allowance for uncollectible minimum lease payments receivable	• Description of significant leasing arrangement • Analysis of commitments under non-cancellable operating leases by period • Contingent rents recognized as income

Leases: Key accounting differences

U.S. GAAP

- Specific criteria for lease classification as operating or capital lease
- Incremental borrowing rate is used to discount minimum lease payments, unless the implicit rate is known and is lower.
- Land and building elements are generally accounted for as a single unit, unless land represents more than 25% of the total fair value.

IFRS

- Principle-based framework is used to classify leases as operating or finance leases.
  - "A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership." – IAS 17
- Generally, the implicit rate in the lease is used to discount minimum lease payments.
- Land and buildings are accounted for separately, if material.

Leases: Other considerations

First Time Adoption

- Basic principle is to classify leases as either operating or finance based on circumstances existing at lease inception.
- The first time adopter may determine whether an arrangement existing at the date of transition to IFRS contains a lease on the basis of facts and circumstances existing at that date.

Accounting Policies and Internal Controls

- Ensure consistency of judgments throughout organization.
- Document basis for judgments / estimates (Adequacy of audit trail).

Income Taxes

- Generally the IFRS treatment of leases is more similar to U.S. tax law; however, book tax differences will remain.

People

- Accounting training at appropriate levels
  - Increased judgment around determining the classification of leases

Information Systems

- Processes and data capture for leases may be more detailed leading to possible information system changes.