A second take

The commercial impacts of a proposed new accounting standard on leases

Ernst & Young

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The commercial impacts of a proposed new accounting standard on leases

On 16 May 2013, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) issued exposure drafts proposing a new accounting model for leases, which would require lessees to record most leases on-balance sheet. The proposals mark a significant change from current operating lease accounting for lessees, which currently are off-balance sheet. Lessor accounting would also be affected, but to a lesser extent.

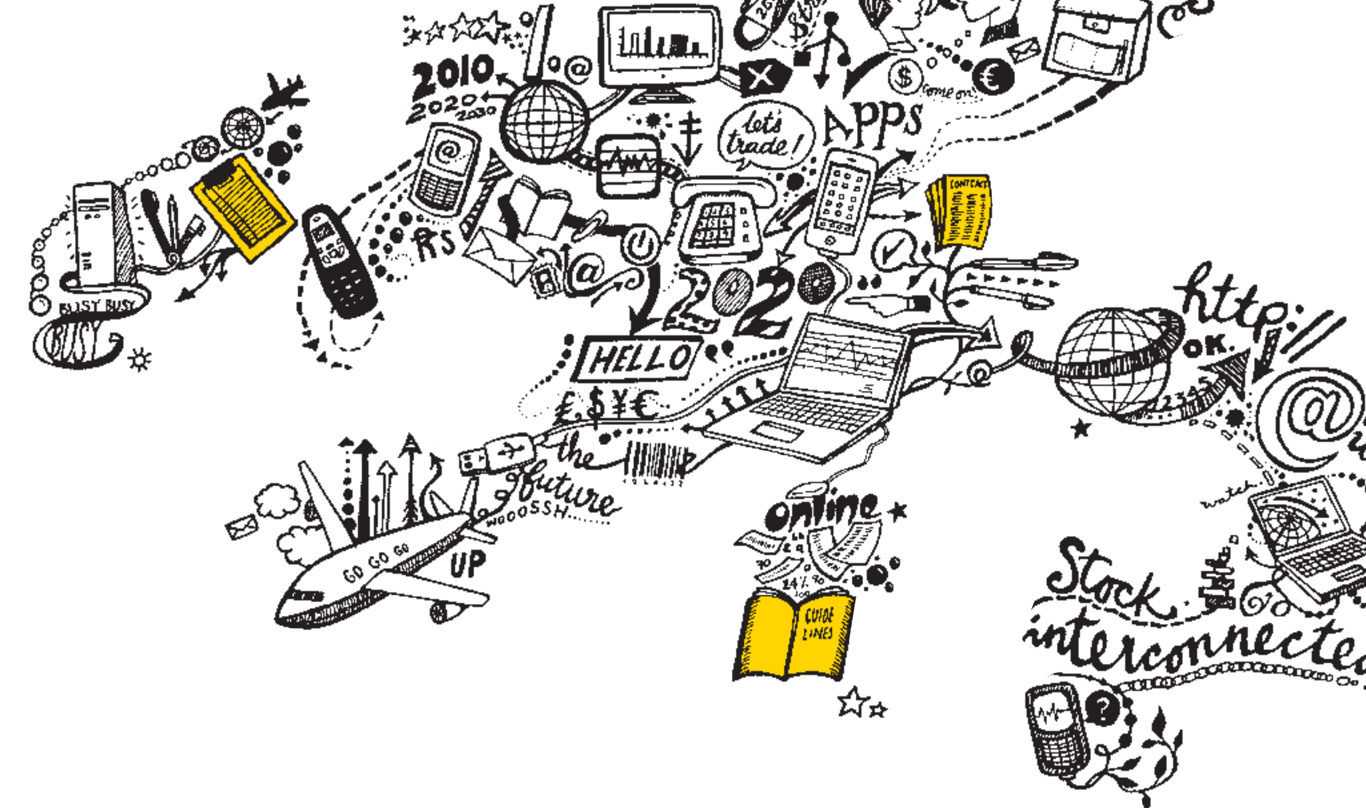
The latest proposals mark the Boards' second round of exposure drafts in their joint project to develop a converged accounting standard on leases under both IFRS and US GAAP. The Boards' first exposure drafts on leases were issued in August 2010, and although there are many changes made from the August 2010 proposals, the primary principle of bringing most leases on balance sheet for lessees has been retained.

As most entities are involved with leasing activities in their day-to-day operations, the proposals are expected to have far reaching impacts across many industry sectors. Additionally, the proposals are expected to have a pervasive effect across an entity's operations and business, including contractual arrangements linked to key financial metrics (e.g. banking covenants), information systems' requirements, income tax implications, and market communications, just to name a few. This publication will analyse what the proposed lease accounting changes mean, in particular, the commercial impacts of these changes.

Background — Why the change?

The major criticism of the existing lease standards is that they fail to meet the needs of investors, analysts and other users of financial statements because lessees do not record all lease obligations on their balance sheets. This is based on what some deem to be an arbitrary distinction between operating and finance leases. For finance leases, a lessee records lease assets and liabilities on-balance sheet. However, operating leases are off-balance sheet, which has driven the claim that leasing transactions (mainly obligations) are not properly reflected in a lessee's financial statements.

Overview of the new lease accounting model



Under the proposed definition, a lease would be defined as a contract that conveys the right to control the use of an identified asset (such as property, plant or equipment) for a period of time in exchange for consideration.

In a key change from the proposals in the 2010 exposure draft, leases would be classified into two types, referred to as 'Type A' or 'Type B' leases.

In general, most leases would be on balance sheet. In particular, lessees would record an asset for the right to use the leased asset, and a liability for the obligation to make lease payments. There is an exception for short-term leases (i.e. leases with a maximum possible term of 12 months or less, including renewal options). Short-term leases can remain off-balance sheet, with lessees/lessors recording lease expense/income on a straight-line basis over the lease term.

In a key change from the proposals in the 2010 exposure draft, leases would be classified into two types, referred to as 'Type A' or 'Type B' leases. Lessees and lessors would use the same principle to classify leases, which would determine the profile of lease income and expense recorded over the lease term. For lessors, this will also affect what is recorded on the balance sheet. Lease classification would depend on the extent to which the lessee is expected to consume the economic benefits embodied in the asset over the lease term. To reduce complexity, lease classification would be based on the nature of the asset being leased:

- Leases of assets that are not property (e.g. motor vehicles, plant or equipment) would be classified as Type A leases, unless either of the following conditions exists:
    - The lease term is for an insignificant part of the asset's total economic life
    - The present value of the lease payments is insignificant compared with the asset's fair value
- Leases of property (i.e. land and/or a building or an identified portion of a building) would be classified as Type B leases, unless either of the following conditions exists:
    - The lease term is for the major part of the asset's remaining economic life
    - The present value of the lease payments accounts for substantially all of the asset's fair value

Lessee accounting

Initial measurement

Lessees would initially record a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the leased asset for the lease term. In general, the lease liability would be recorded at the present value of the lease payments. The right-of-use asset would be measured at cost, based on the amount of the lease liability, plus any prepayments and the lessee's initial direct costs. Both the lease liability and the right-of-use asset would be recorded net of any lease incentives received or receivable from the lessor.

Subsequent measurement

For both Type A and Type B leases, the lease liability recorded by lessees would reduce over time, as lease payments are made. The liability also would be adjusted for effective interest arising from unwinding the discount on the liability.

For Type A leases (e.g. equipment leases), the right-of-use asset would be amortised (i.e. written off) to the income statement over the term of the lease, typically on a straight line basis. This treatment results in the front-end loading of lease-related expenses, when the straight-line amortisation expense is coupled with the recorded interest on the lease liability, because interest expense will be higher in the earlier years of the lease.

For Type B leases (i.e. property leases), however, the accounting model is designed to result in a straight-line expense pattern, similar to the straight-line expense pattern for many operating leases today. This is achieved by lower amortisation expense on the right-of-use asset in the earlier years of the lease, to offset the higher interest expense on the lease liability, to result in an overall straight-line expense pattern.

Income statement impacts for lessees are discussed further below.

Lessor accounting

Lessors would account for Type B leases similar to today's operating leases (i.e. the property remains on-balance sheet, and the lessor records lease revenue typically on a straight line basis over the lease term).

Type A leases (e.g. equipment leases) would be accounted for similar to the current treatment of finance leases (e.g. lessor removes the leased asset from its balance sheet and records a lease receivable, residual asset, and profit, if any). Subsequently, lessors would record interest income for the accretion of the lease receivable and the residual asset (using the effective interest method) and reduce the lease receivable for payments received.

Transition

The proposals allow full retrospective or modified retrospective application of the standard. Under both approaches, entities would record lease-related assets and liabilities as of the beginning of the earliest comparative period presented. The modified retrospective approach would allow entities to use certain shortcut calculations to initially measure lease-related assets and liabilities, and hindsight to determine the lease term or whether a lease exists at all. Grandfathering of leases is not allowed under either approach.

Commercial impacts of the proposed changes

Based on the brief accounting summary outlined above, lessees and some lessors will experience a pervasive impact – impacts that go well beyond just accounting. Of course, the extent of impact on a particular entity would vary depending on the extent of its lease transactions, how the leases were previously accounted for (operating vs. finance) and factors such as length of lease term and other specific lease provisions.

Impacts on the balance sheet, gearing and banking covenants

The most obvious change to a lessee's financial statements is the substantial increase in recorded assets and liabilities for entities that have significant operating lease commitments. Depending on your balance sheet structure and composition, the recording of operating lease commitments on balance sheet could have a detrimental impact on your gearing and working capital ratios.

For lessees, fundamentally altering these ratios can have major consequences for your banking covenants and any other contractual arrangements linked to these ratios. Therefore, it will be important to consider the implications of the proposals before the changes become effective, including when establishing or refinancing any long-term borrowings over the next few years.

In addition, the proposed requirement to reassess the lease liability (for lessees) and lease receivable (for lessors) will result in increased balance sheet volatility. Adjustments will be made for changes in expectations relating to lease renewals, purchase options, residual value guarantees and/or changes in an index or rate on which variable lease payments are made. Differences between the accounting and tax treatments of leases could result in the recording of deferred tax assets or liabilities, further impacting the balance sheet structure. (Other tax issues are discussed below.)

In order to minimise the effect on balance sheets, the proposed model could affect the way lease arrangements are negotiated and structured.

Impacts on the income statement – Type A leases

For lessees with Type A leases (e.g. equipment leases), operating lease expenses currently recorded in the income statement will be replaced with amortisation of right-of-use assets and interest expense on the unwinding of the discount on lease liabilities. This changes the nature of the expense – from equipment rental (or similar) to amortisation and interest. Measures such as EBIT or EBITDA would improve, potentially impacting on business valuation methodologies, employee performance measures, banking covenants and other contractual arrangements that are based on EBIT or EBITDA multiples or hurdles. Other potential impacts on banking covenants, such as interest times cover ratios, should also be considered.

In addition, the timing of when lease-related expenses are recorded in operating profit will change. Recording interest expense on the unwinding of the discount on lease liabilities (using the effective interest method), in conjunction with amortisation for the right-of-use assets, will generally result in a different expense profile compared with the existing "straight-lining" of operating lease rentals under the existing accounting standard. In many cases, the proposals will result in higher lease-related expenses in the early years of the lease.

For lessors with Type A leases that were previously classified as operating leases, the lease-related income profile under the proposals would also be different to legacy operating lease accounting. Under the proposals, interest income recorded on the unwinding of the discount (on the lease receivable and the residual asset) generally will result in higher lease-related income in the early years of the lease compared with the existing "straight-lining" of operating lease rentals under the existing accounting standard.

Impacts on the cash flow statement

Under the existing accounting standard, operating lease payments by lessees are generally classified as cash outflows from operating activities. This classification would remain consistent for payments by lessees arising from Type B leases under the proposed model. For Type A leases, repayments of the principal portion of the lease liability would be classified as financing cash flows, and payments of interest would be classified in a consistent manner by lessees in accordance with NZ IAS 7 Statement of Cash Flows as operating, investing or financing cash flows. For lessors, cash receipts from lessees will be presented as cash flows from operating activities for both Type A and Type B leases.

Impacts on internal processes

As previously mentioned, the proposals in the exposure draft would require that the new standard be applied to all existing leases at the beginning of the earliest comparative period presented (using the modified retrospective approach). Entities would need to review key provisions such as lease terms (including possible extensions), residual value guarantees, purchase options and term option penalties on all of its existing leases, and consider whether their accounting systems are sufficiently robust to deal with the annual reassessment and re-measurement process. For many entities, accounting for most leases might have been relatively straightforward under the existing accounting standard, mainly resulting in the recording of monthly rental expense for lessees and rental income for lessors. Under the proposals, not only would management estimates be required to initially record the lease, but an ongoing assessment of key measurement assumptions would also be necessary each reporting period. Accordingly, an entity would need to establish accounting policies and design processes and internal controls to make certain that input from operational and financial management is sought, analysed, documented and processed.

Many entities will need to establish more refined systems because current systems (e.g. excel spreadsheets) might not have sufficient depth to capture and manage all of the critical data needed to account for lease transactions under the proposed approach. While some entities may want to design their own IT systems to address the proposed requirements, others may decide to purchase or integrate lease systems that outside vendors will most likely develop as the lease proposal progresses to a final standard.

Impacts on tax

Lessors and lessees would need to analyse accounting/tax differences that would result from application of the lease proposal. As noted earlier, differences between the accounting and tax treatments of leases could result in the recording of deferred tax assets or liabilities, further impacting the balance sheet structure.

Also, as entities potentially modify existing lease arrangements to address the accounting treatment under the proposed new standard, the impact on existing tax treatments would need to be assessed and tax risks going forward would need to be appropriately managed. This would take on greater importance for an entity with significant leasing activities.

In addition, the proposed changes to the treatment of leases for accounting is likely to have significant impact on thin capitalisation calculations required to be made by certain taxpayers. The lease liability created under the new accounting proposals should not be included in the total debt component of the thin capitalisation calculation, as the lease liability should not be considered a financial arrangement where funds have been provided. However, the lease asset created under the new accounting proposals should be included in the total assets component of the thin capitalisation calculation as total assets are based on generally accepted accounting practice, being the value of the assets shown in the financial statements of the entity's New Zealand group or the net current value of the assets. Accordingly, it is likely the proposed accounting changes to leases will improve the thin capitalisation calculation and help taxpayers fall below the thin capitalisation safe harbour thresholds.

Changing corporate behaviour

In order to minimise the effect on balance sheets, the proposed model could affect the way lease arrangements are negotiated and structured. For example, shorter lease terms, especially shorter non-cancellable periods, would generally result in less grossing-up of the balance sheet for lessees. However, entities would need to weigh the desire for a smaller balance sheet effect against the higher costs of lease renewals that would possibly result. For lessors, shorter lease terms would result in greater renewal risk and higher financing costs. Some entities might also seek to modify existing leases. Still others may reassess their entire lease-versus-buy strategies.

Next Steps

The IASB and FASB have invited comments on their proposals by 13 September 2013. The Boards will then consider the comments received before finalising the standard.

Although the effective date of a new leasing standard is expected to be at least two years away, organisations should begin to assess the resulting impacts now. Existing leases as of the date of initial application would need to be assessed under the new standard, not just those entered into after the standard becomes effective.

As the new lease standard presents more than just accounting issues, performing an impact assessment early, even at a high level will enable an entity to analyse the potential effects of the proposals, so that meaningful communication with stakeholders can take place as needed, and other action plans can be developed. Organisations that begin to address these issues early will be in the best position to successfully migrate to the new lease standard, including avoiding any potentially unpleasant 'surprises' when the standard comes into effect.

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