Lease resistance

PETER WILLIAMS LOOKS AT THE ACCOUNTING STANDARD SETTERS' PROPOSALS TO PUT LEASES ON THE BALANCE SHEET.

One of the last great unreformed areas of financial accounting is coming under the scrutiny of global accounting standard setters and radical reform is on the agenda. In the summer the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published proposals to "improve the financial reporting of lease contracts". In their recently revised work plan update, the IASB/FASB identified leasing as one of the five high-priority issues for significantly improving current accounting and convergence.

But even after extensive consultation, resistance persists, especially in the leasing industry. The standard setters believe that, if adopted, the proposals would improve the financial reporting information available to investors about the financial effect of lease contracts.

Accounting under the existing requirements depends on the classification of a lease. Classification as an operating lease results in the lessee not recording any assets or liabilities in the balance sheet either under IFRS or US standards. According to the standard setters, this results in many investors having to adjust the financial statements, using disclosure and other available information, to estimate the effects of lessees' operating leases for the purpose of investment analysis (see Box 1).

The standard setters believe that their proposals would result in a consistent approach to lease accounting for both lessees and lessors, a so-called right-of-use approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position.

The battle over lease accounting extends back decades and the latest proposals have been developed by IASB/FASB following a March 2009 discussion paper (Leases: Preliminary Views), which generated over 300 comments.

The exposure draft proposed that all leases should be shown on balance sheet, thus removing the anomaly of operating leases being treated as off balance sheet and dumping the risks and rewards concept. While there is widespread support for the principle that all leases should be treated on balance sheet in the same way, there are still divergent views of how such assets and liabilities should be measured and remeasured.

Under the proposals, lessees will recognise a right-to-use asset and an obligation to make lease payments initially measured at the present value of the expected outcome of the lease payments discounted at the lessee's incremental borrowing rate. Thereafter the right-to-use asset will be depreciated and liability will be amortised using an effective interest method. However, the original estimates of expected outcome for some leases will

Box 1: Balance sheet shenanigans

THE TREASURER SPOKE TO ANDREW TEMPEST, GROUP REPORTING MANAGER OF EASYJET, ABOUT THE PROPOSALS.

Giving his personal view, Tempest said: "I welcome the proposals because the current distinction between operating and finance leases is essentially a set of rules which both lessors and lessees do their best to exploit in order to arrive at the answer they want."

He pointed out that some of the comments submitted to the IASB acknowledged that they objected to the proposed changes because it would remove the ability to practice off balance sheet financing.

Tempest said: "There is an increasing sympathy for the view that if you don't put leases on the balance sheet then you are understating your financial liabilities."

In practice analysts have long adjusted the reported figures of companies in an attempt to make an allowance for the impact of leasing on balance sheets, and easyJet is no exception. Tempest said: "Our investors already adjust our balance sheet to include an estimated liability for operating leases." The investors multiply the published operating lease payment figure by seven as a "gearing adjustment".

So common is this practice in the aviation sector that easyJet provides the figure. However, this shortcut does not accurately reflect the effects of changes in foreign exchange rates, interest rates or the average remaining lease term.

Although the final leasing standard is unlikely to impact companies for a few years yet, Tempest is already doing high-level calculations to estimate the net present value of the lease liability as easyJet does not presently monitor that figure. Inevitably the new standard will cause more work for reporting teams and treasurers.

Tempest said he knew of one company with 2,500 leases; the system implication for coping with that is a substantial challenge. By contrast easyJet has around 70 leases and expects to be able to perform the work using existing systems, including its new treasury management system.

almost certainly need to be re-estimated as circumstances change.

IASB/FASB's proposals have been influenced by a need to make them consistent with decisions taken on related projects, such as revenue recognition. The problem with this approach, according to commentators, is that it leads to a level of complexity in the measurement and remeasurement of leased assets and obligations that corporates may find unwelcome.

Another unwelcome consequence is that the accounting will increase the gearing for heavy users of operating leases and the total expense for depreciation and interest will be front-end loaded in the early periods of the lease, in much the same way as if lessees had financed the assets with debt. Sectors most affected will be those that have leases of large capital values and long asset lives, such as real estate and transport assets (ships, aircraft, commercial vehicles and so on). On the basis of a 2009 study it conducted with the Rotterdam School of Management, PwC said the real estate sector could see its levels of gearing double.

IMPACT ON LESSORS According to KPMG, lessors would also be impacted by the proposed changes with two very different models proposed: the performance obligation approach and the derecognition approach. Under the performance obligation model, the lessor would recognise the leased asset, an asset for the lease rentals and a liability for permitting use of the leased asset. Under the derecognition model, the lessor would derecognise the leased asset and recognise an asset for the lease rentals and a residual value asset for its interest in the leased asset at the lease end.

The performance obligation approach would be more likely to apply to lessors with leases that are currently classified as operating, while the derecognition approach would be more likely to apply to leases that are currently classified as finance leases.

Lessors who currently treat leases of investment property at fair value are exempt from the proposals.

The transition to the new proposals would require every existing lease to be reanalysed. In some cases, particularly for lessors and lessees with large leasing portfolios, the system changes required will be significant.

LAST GREAT BATTLE For the standard setters this is one of the last great off balance sheet battles. Sir David Tweedie, chairman of the IASB, jokes that his ambition is to fly in a plane which is actually on the airline's balance sheet. He said: "The leasing industry plays an important role in many economies by helping companies manage cashflow and working capital. However, much of the estimated annual $640bn of lease commitments fails to appear on the balance sheet of lessees, thereby giving a false impression of companies' liabilities and gearing."

But his view is not shared by the leasing industry. The UK's Finance & Leasing Association has warned that the proposals would make asset finance more difficult to obtain because the changes are not being co-ordinated with existing capital requirements regulations and so hamper economic recovery. The FLA said that under current rules for reporting operating leases businesses' accounts show the actual rent paid for equipment, but that under the proposals they would have to prepare theoretical estimates of the value and cost of the lease and include these on their balance sheets. It said that this would create extra administrative burden and accounting uncertainty and it called on the IASB "to carry out a proper cost-benefit assessment and to drastically simplify its proposals".

Julian Rose, head of asset finance at the FLA said: "The IASB's proposals involve taking real numbers and replacing them with a mish-mash of accountants' assumptions, estimates and adjustments. The proposals appear to ignore the IASB's own discussions on lessor accounting merely to permit convergence with US accounting regulators."

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The exposure draft is open for comment until 15 December.

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Box 2: Leasing Q&A

THE TREASURER ASKED PETER HOGARTH, A PARTNER IN ACCOUNTING CONSULTING SERVICES AT PRICEWATERHOUSECOOPERS, FOR HIS VIEWS ON THE PROPOSALS.

TT: The proposals would result in a consistent approach to lease accounting for both lessees and lessors, a "right of use" approach. Is this a better approach than the current one?
Hogarth: "The distinction between operating and finance leases is somewhat artificial and there is a lot to be said for approaching all leases in the same way. But many argue that the proposals go too far by including optional term extensions and estimates of contingent rent in lease liabilities. For lessors, two different approaches are proposed, so inconsistencies will remain."

TT: Sir David Tweedie says much of the estimated annual $640bn of lease commitments fails to appear on the balance sheet of lessees, thereby giving a false impression of companies' liabilities and gearing. Do you agree?
Hogarth: "Many investors already adjust for off balance sheet leases, so the impact on investor perceptions might not be as great as some fear."

TT: What will be the impact on the balance sheet for major corporates and what should treasurers do?
Hogarth: "Reported levels of debt will increase, sometimes substantially, but so will EBITDA for many companies. Treasurers should assess the potential impact early as lease agreements and covenant tests attached to other debt may need to be renegotiated."