ALL THINGS BEING EQUAL

NEW ACCOUNTING RULES ARE SET TO ENSURE THAT ALL LEASES ARE TREATED IN THE SAME WAY. ROBERT KING AND PAUL LIPPITT EXPLORE THE CHANGES AND THEIR POTENTIAL IMPACT ON FINANCIAL REPORTING

At present, the accounting treatment of leases is driven by their classification. In accordance with IAS 17, *Leases*, lessees are required to report finance leases as depreciating assets, with a corresponding debt obligation, whereas operating leases are reported as commitments within the notes to the accounts.

This lack of consistency has driven the International Accounting Standards Board (IASB) to develop a new lease accounting standard so that, for lessees, all leases are treated in the same way. This will make it easier to compare different organisations with leased assets and will eliminate some of the current approximations that analysts use, including those from credit rating agencies.

The final form of the new rules is expected to be announced towards the end of 2015, although there is likely to be a period of transition before they come into effect for organisations reporting under IFRS and UK GAAP.

What are the key differences?

Under the new standard, all leases will be recorded on-balance sheet, whether they are currently classified as operating or finance leases, except for low-value items (for example, office equipment and IT). A 'right of use' asset is created, based on the discounted value of remaining lease payments together with a corresponding lease liability. While the 'right of use' asset is depreciated straight line, interest costs are charged on a declining balance basis, following the declining value of the lease liability, as this is repaid. An exemption will apply for leases with less than one year to run, or where there is a service element or service contract.

It should also be noted that there is currently a divergence of approach between the IASB and the Financial Accounting Standards Board (FASB), under whose rules US-listed companies report. Although there is agreement in terms of the principle of recognising all

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leases on-balance sheet, under the proposed FASB rules the major difference is the recognition of operating lease expenses on effectively a straight-line basis, which will lead to differences in the timing of profit and loss (P&L) costs, EBITDA and cash-flow reporting. This note focuses on the proposed IASB approach.

Impact of the changes

Organisations that currently finance assets via operating leases will be impacted by the following financial performance measures:

- **EBITDA** – As operating-lease commitments will be treated as depreciation and interest charges with these costs will be treated 'below the line' for EBITDA purposes, it is expected that EBITDA will increase.
- **P&L account** – Due to the front-loading of interest, it is likely that P&L costs will be higher initially, but will reverse in later years.
- **Balance-sheet gearing** – This is expected to rise due to the creation of an asset and liability reported on the balance sheet.
- **Retained reserves** – This will be affected via a transitional adjustment to reflect the impact of prior years. This may be positive or negative depending upon the value and timing of future rentals.
- **Operating cash flow** – As operating lease costs will be reclassified as financing activities, these will tend to increase operating cash flow, although overall cash flow should remain unchanged.

What are the implications?

The proposed new rules are a welcome simplification from the earlier draft lease accounting standards that required lessees to classify leases as either Type A or Type B. The proposed new rules also remove the requirement for lessees and their auditors to assess if a lease is an operating lease or not, as is the case under the current rules. Under the new rules, all leases are on-balance sheet, with a few minor exemptions as noted above, and follow a similar methodology to existing finance leases.

In general, however, lessees would be best placed to review their banking covenants with their lenders and ensure that the resulting changes to financial measures are understood by both parties. Organisations would benefit from reviewing their IT systems and software to see whether these need to be enhanced to accommodate the new financial reporting requirements. They may also need to undertake financial modelling to understand the likely impact on their key financial performance measures and consider what action may be required as a result.

For organisations with motor vehicle leases, the challenge will be managing the volume of transactions and potentially contract variations. This will mean lessors will need to provide better management information to support:

- **Financial control** – reconciling monthly lease invoices to P&L charge and lease liability.
- **Variation of assets** – for example, rescheduling lease terms and mileages, and early terminations.
- **Transfer of assets** – between subsidiary companies within the same group.

Corporates with big-ticket lease commitments (for example, airlines or property leases) may see a significant impact on their balance sheet and financial performance measures, and might need to work with investors and analysts to ensure that all parties understand the impact of the changes. The changes may not always be detrimental to how investors assess the credit strength of corporates – many rating agencies and banks currently use a crude adjustment to reported debt for operating lease commitments (for example, Moody's often applies an adjustment to debt equal to a multiple of the current year operating lease obligations), and the proposed new rules are intended to give investors a fairer and more accurate view.

HOW TO PREPARE FOR THE LEASE ACCOUNTING CHANGES

Organisations would benefit from starting to plan now for the proposed changes to lease accounting and consider the following steps:

- **ENSURE** that data is collected and recorded for all leases entered into.
- **DECIDE** whether systems need to be upgraded to accommodate the changes.
- **ENGAGE** with lenders to ensure that the impacts on banking covenants are understood and taken into account.
- **EVALUATE** the likely impact on key financial performance measures (see earlier) and review options for minimising any adverse consequences (for example, rescheduling leases in advance of the new rules coming into force).
- **WORK** with lease providers to ensure required management information will be available to support the proposed accounting changes.
- **CONSIDER** how assets should be funded going forward, including changing lease-payment profiles and using alternative funding solutions.


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