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Heads Up
IASB issues Project Update *Practical implications of the new Leases Standard*

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"In summary"

In March 2015, the IASB issued a Project Update *Practical implications of the new Leases Standard*. This Project Update summarises the IASB's lessee accounting model and also provides a comparison to the model developed by the US standard setter, the FASB. It also highlights some possible effects of the changes to lessee accounting.

The IASB model:
- **Balance sheet:** Recognise lease assets and liabilities on the balance sheet, initially measured at the present value of unavoidable lease payments;
- **Income statement:** Recognise amortisation of lease assets and interest on the lease liabilities over the lease term; and
- **Cash flow statement:** Separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

The effects of the IASB model:
- **Balance sheet:** An increase in lease assets and financial liabilities. In addition, there may be a reduction in reported equity due to differences in amortisation profile and interest recognition. The actual effect will be dependent on the lessee's leverage, the terms of the leases, the ratio or lease liabilities to equity and the age of the lease.
- **Income statement:** Higher EBITDA, higher operating profit and higher finance cost.
- **Cash flow statement:** Higher operating cash inflows and higher financing cash outflows, assuming interest reported within operating activities.
- **Other:** Changes in key ratios (eg. leverage and performance ratios).

The new Leases Standard will be more than just accounting changes. There will be a number of commercial implications to consider such as:
- Systems requirements;
- Covenants on existing loans and borrowing arrangements;
- Existing remuneration schemes, bonuses and share-based payments; and
- Education of stakeholders.

The IASB is yet to decide on the effective date. However, they plan to issue the new Standard before the end of 2015. We anticipate that the effective date would not be earlier than years beginning on or after 1 January 2018.

Project background

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (The Boards) have been working together to improve lease accounting. Both Boards believe that a customer (lessee) leasing assets should recognise assets and liabilities arising from those leases (including leases that are off balance sheet today).

The Boards jointly published a revised Exposure Draft Leases (the 2013 ED) in May 2013. However after extensive feedback, the Boards have redeliberated almost all aspects of the project. The Project Update is a summary of the IASB's lessee accounting model after these discussions.

The IASB and the FASB models are not converged and therefore the Project Update also provides a comparison to the FASB's model.

The IASB will decide on the effective date of its new Leases Standard in the coming months and plans to issue the new Standard before the end of 2015.

Balance sheet

The IASB decided that lessees would be required to recognise assets and liabilities arising from all leases on the balance sheet. However, the IASB decided not to require a lessee to recognise assets and liabilities for (a) leases of 12 months or less and (b) leases of small assets.

The IASB decided that a lessee would measure lease liabilities at the present value of future lease payments. However, the lease liability would include only economically unavoidable payments. Lease liabilities will be presented on the balance sheet in accordance with the same requirements as for other financial liabilities.

Initially lease assets would be measured at the same amount as the lease liability. However, lease assets will also include costs directly related to entering into the lease. The lease asset will then be amortised in a similar way to other assets such a property, plant and equipment. Lease assets will be presented together with other owned assets based on the nature of the underlying asset (eg. owned property, plant and equipment) or as a separate line item.

Income statement

The IASB decided that lessees would always recognise and present (a) amortisation of a lease asset separately from (b) interest on the lease liability. Under the current operating lease model, lease payments would form part of operating expenses and would be included in earnings before interest, tax, depreciation and amortisation (EBITDA). Under the new model the implicit interest in the lease liability will be presented as part of finance cost (i.e. not part of EBITDA). Furthermore, the amortisation of the lease asset will also not form part of EBITDA.

The overall effect of the new model on profit before tax will depend on the portfolio of leases an entity holds. However in the earlier years of a lease, the net profit before tax will be lower the under the current operating lease model as a result of higher interest accruing on the lease liability in the earlier years of the lease.

Cash flow statement

The IASB decided that (a) the principal portion of the lease liability cash flows would be presented as part of financing activities and (b) the interest portion of the lease liabilities in accordance with the requirements related to other interest paid i.e. either operating or financing.

Transition

The IASB decided that for leases previously classified as operating leases, a lessee can choose either a fully retrospective or modified retrospective approach on transition. The fully retrospective approach would include restating all elements of the lease portfolio as if the revised requirements have always been applied, together with the restatement of comparatives. The modified retrospective approach includes recognising the cumulative effect of applying the revised requirements in opening retained earnings in the year of adoption and some other practical expedients and choices. No restatement of comparatives would be required, but additional disclosures will be required to mitigate the lack of comparability. The different transition approach will result in different profit impacts in the year of adoption and therefore transition will need to be carefully considered.

Other observations

The Project Update provides a summary of differences between its model and that of the FASB. In summary the FASB lease model requires lessees to recognise:

- Lease assets and liabilities on balance sheet (consistent with the IASB model);
- A straight-line lease expense over the lease term (consistent with the current operating lease model, rather than the IASB model that requires separation between amortisation and interest); and
- Total cash paid within operating activities.

The Project Update also includes an illustrative example of the effects of the new model for a retailer, airline and distributor.

For a more detailed summary of the IASB's project on leases, please visit Deloitte's IASplus website.