

LEASE ACCOUNTING WHAT LIES AHEAD?



Leasing has been topical among accountancy and finance professionals for quite a long time. **Brian O'Callaghan** and **Goind Ram Khatri** discuss some recent developments and describe the potential challenges for reporting entities.

Sir David Tweedie, the former Chair of the International Accounting Standards Board (IASB) has often said that it is his ambition to fly on an aeroplane that is actually on an airline's balance sheet before he retires. It is likely that he may get his wish in the near future, albeit after his retirement.

The existing accounting standard on leases, IAS 17, has been criticised, among other things, for:

- not demonstrating fairly all the rights and obligations that parties to a lease incur;
- allowing exploitation of the operating lease definition for off-balance sheet financing; and
- reducing comparability in the review of financial statements due to the two distinct lease categories.

The IASB has admitted that IAS 17 does not provide users of financial statements

with enough information to make decisions, especially in the case of operating leases.

As a result, the IASB and the Financial Accounting Standards Board (FASB) (the 'Boards') jointly established a project and published an exposure draft (ED) on leases in August 2010.

Extensive deliberations and a re-exposure of the draft followed and the Boards' redeliberations have highlighted the importance of lease accounting providing users of financial statements with a complete and understandable picture of an entity's leasing activities.

This article looks at some of the key tentative decisions reached to date and considers the future challenges for reporting entities.

LESSEE ACCOUNTING

The Boards tentatively decided to adopt a right-of-use model for lease arrangements for lessees (except for short-term leases). A

right-of-use model incorporates two different approaches – an accelerated expense approach and a straight line approach. Under both approaches a lessee would recognise a right-to-use asset and a liability to make lease payments at the present value of lease payments. However, there would be different lease expense recognition patterns under each of the proposed approaches.

The accelerated-expense approach

For leases in which the lessee acquires and consumes more than an insignificant portion of the underlying asset, the liability to make lease payments would be measured using the effective interest method and the right-to-use asset would be amortised/depreciated using a systematic and rational method (the accelerated expense approach). Therefore, the expense recognition pattern would be on an accelerated basis. The interest and amortisation/depreciation expense amounts would be presented within profit or loss.

The straight-line approach

For leases in which the lessee does not acquire or consume more than an insignificant portion of the underlying asset, the liability to make lease payments would be measured using the effective interest rate method while the amortisation/depreciation of the right-to-use asset would be measured as a balancing figure such that the total lease expense would be recognised on a straight line basis regardless of the timing of lease payments. The interest and amortisation/depreciation expense amount would be presented as a single-line item as lease expense in profit or loss.

LESSOR ACCOUNTING

The Boards tentatively decided there should be two different types of leases for lessor accounting (excluding short-term leases): the 'receivable and residual approach' and an approach for leases excluded from the scope of the receivable and residual approach.

The underlying principle in distinguishing between leases subject to the receivable and residual approach and those excluded from the scope of the receivable and residual approach would be based on whether the portion of an underlying asset that is deemed to be sold to the lessee represents more than an insignificant portion of the underlying asset. The principle should be applied using a practical expedient based on the nature of the underlying asset.

The receivable and residual approach

For leases in which the lessor is deemed to have sold more than an insignificant portion of the underlying asset to the lessee, the lessor would reflect the accounting under the receivable and residual approach as follows:

- initially measure the lease receivable at the present value of lease payments discounted using the rate charged in the lease and subsequently amortised using the effective interest method;
- initially measure the residual asset on an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts: (a) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term, discounted using the rate that

the lessor charges the lessee net of (b) deferred profit, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset;

- subsequently measure the gross residual asset by accreting to the estimated residual value at the end of the lease term using the rate that the lessor charges the lessee. The lessor would not recognise any of the deferred profit in profit or loss until the residual asset is sold or released;
- present the gross residual asset and the deferred profit together as a net residual asset.

Leases excluded from the receivable and residual approach

For leases in which the lessor is not deemed to have sold more than an insignificant portion of the underlying asset to the lessee, the lease would not be within the scope of the receivable and residual approach and would account for the lease based on the current operating lease accounting model.

SHORT-TERM LEASES

A short term lease is defined as a lease that, at the date of commencement of the lease, has a maximum possible lease term, including any options to renew or extend, of 12 months or less. The Boards tentatively decided that both lessees and lessors would present the expense or income from short-term leases as lease expense or lease income which is consistent with the current operating lease treatment. Lease payments on short leases would be recognised on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

FUTURE CHALLENGES

While the objective of the proposed changes in accounting for leases is to eliminate the issues with the previous model and provide users of financial statements with a complete and understandable picture of an entity's leasing activities, challenges remain. These include the following:

- Understanding the impact of lease contracts in the financial statements will remain a challenge, and in reality will become more complex. One of several approaches may now be relevant under

the new models, compared with the previous finance/operating distinction. More judgement and potentially more subjectivity will also be involved in determining the appropriate approach.

- More onerous and complex calculations will be required by certain companies and system enhancements may be necessary to cope with the demands of the new proposals;
- Without any change in the substance of company transactions, results and analysis of performance may change. Assets may now be capitalised resulting in a lower return. Debt to equity ratios will change and, on a practical level, these types of changes may impact loan covenants.
- The view is held by some that lease terms will become shorter to minimise lessee lease obligations;
- Companies will also need to consider how the tax accounting methods and deferred tax positions will be affected by the recognition of additional lease assets and liabilities on the balance sheet, for each relevant jurisdiction. Will significant financial statement changes arising from the new standard impact global tax planning, distributable reserves, inter-company financing arrangements and transfer pricing in that jurisdiction?

CONCLUSION

The Boards are proposing a number of significant changes to the existing accounting standard on leasing which could affect most lessors and lessees. Although any changes will not be effective until a final standard is implemented, companies reporting under IFRS would do well to consider the likely impact of the proposals on their accounting for leases.

What is clear at this stage is that complex implementation challenges lie ahead. As companies evaluate the potential impacts of a new lease standard, their attention must be focused on not only the finance and accounting implications, but also on other relevant areas including tax, systems and investor and financier education. ■

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