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Update on Lease Accounting **August 2008**

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A lot has happened recently in the field of lease accounting. After months of relatively slow progress on the leases project, the IASB has picked up the pace of lease accounting reform, albeit on a simplified basis.

Over the past months, a number of (important) jurisdictions have agreed to adopt International Financial Reporting Standards (IFRS) by no later than 2013. To facilitate this adoption, the IASB has decided not to produce any new standards in the year or so leading up to this date, a similar process as to when the EU first adopted IFRS in 2005. The 2013 target therefore implies that the IASB will need to complete all major new standards by June 2011 latest.

As a result, a group of four Board members was asked to identify which ongoing projects, part of the IASB/FASB Memorandum of Understanding (MoU) to converge and improve standards, were still realistic before the June 2011 deadline. The group reported its findings to the IASB in April, recommending for the leasing project that lessee and lessor accounting be dealt with separately and that work focus only on lessee accounting in order for substantial improvements to be made to this area of IFRS in time for the deadline. The main reasons given to justify this proposal were that the lessee section of the existing standard presents “serious deficiencies” (read allows off balance sheet treatment) and that lessor accounting is a “relatively low priority for investors and some Board members”. The group also suggested that accounting for lessees be simplified in relation to what had been discussed by the Boards in the past, as issues such as contingent rents and options were slowing down the project.

Although the Board did not take any formal decision to split the leases project at that stage, IASB staff was asked to present a revised technical plan for leases along the lines of these recommendations to the Board for their June meeting. During this meeting, several Board members expressed disappointment that lessee and lessor accounting were to be separated. The industry reaction was also clear. The US Equipment Leasing and Finance Association (ELFA), the UK Finance and Leasing Association (FLA), the Canadian Finance and Leasing Association (CFLA) and Leaseurope all wrote to the IASB opposing the split and calling for a better conceived, fundamental review of lease accounting that should include lessor accounting. However, the strong opposition of the international leasing industry was not enough to get the Boards to change their minds and during their July meeting, the IASB ended up voting in favour of splitting the project.

Where does this leave lessor accounting? Lessor accounting raises issues that are currently being addressed in other projects, such as the revenue recognition project (part of the MoU) and the derecognition project, currently on the Boards’ research agenda. Consequently, the Boards would like to wait until these standards have been completed before they begin work on lessor issues. With the deadline for completion of the revenue recognition project being June 2011, at best it would be a number of years from this date before lessor accounting is resolved.

To say that the international leasing industry is disappointed with the direction the project is taking is an understatement. Indeed, lessors have had concerns with lessor accounting issues for years – these flaws will now remain for an unknown period of time. Moreover, although it is easy to understand the imperatives underpinning the IASB's decision, a quick-fix solution, limited to lessee accounting, is far from the fundamental review of all aspects of lease accounting promised by the IASB at the outset of the project.

On the bright side however, proposals for lessee accounting are at least likely to be simpler than those originally envisaged under a full G4+1 approach, although this does not imply that some of the aspects of lease accounting currently under consideration by the Boards will not be damaging to leasing.

During their July meetings both the IASB and FASB voted in favour of applying an adapted finance lease model to all leases and treating all leases under one approach. Moreover, the Boards decided that options to extend or terminate a lease contract should not be recognised separately. This is perhaps one of the most positive aspects to come out of recent IASB/FASB discussions. Indeed, industry has been pointing out for a long time (since the publication of the G4+1 papers) that lease option measurement would be an unduly burdensome and perhaps impossible task. Such options will now intervene in determining the "substantive lease term", which becomes the unit of account for leases. Exactly how the substantive term would be determined gave rise to considerable debate among Board members, with the IASB not reaching a clear decision and FASB deciding that the term should be determined by using a non probability-weighted "best estimate". Whatever the final decision on this issue turns out to be, what the Boards would like to avoid is that a 5 year lease with a 3 year extension option likely to be exercised is accounted for as a right of use asset measured at the present value of 5 years worth of rentals when from the outset it is clear that the lessee's right of us asset will actually be worth more.

The Boards also decided to depart from current IAS17 treatment for contingent rents (which requires that such payments be expensed in the period in which they occur). The new approach for lessee accounting would recognise contingent rentals within the lessee's "expected lease payments". Again, precisely how this should be measured was not clearly decided, the IASB preferring a probability-weighted approach and the FASB a non probability-weighted approach to calculating expected lease payments.

With respect to measurement, the Boards gave up on the idea of using fair value measurement and agreed that a lessee should initially measure its right of use asset and the corresponding obligation at the present value of lease payments (including contingent rents). They also decided that the discount rate should be the lessee's incremental borrowing rate for secured borrowings. Regarding subsequent measurement, the IASB opted for today's approach to depreciation while FASB was undecided. Indeed, some FASB members were supportive of an approach proposed by ELFA that would see the right of use asset depreciated using an annuity method and a rental expense being recognised in the P&L statement instead of amortisation and an interest expense. What is certain is that the application of straight line depreciation to the right of use asset will have an impact on lessees' P&L results (see box below).

The IASB now expects to release a Discussion Paper on lessee accounting in November 2008. A meeting of the joint IASB/FASB Leases Working Group is planned in advance of publication. A meeting of the Working Group is more than timely, particularly as the group's last meeting was its inaugural meeting in February 2007.

Further information on lease accounting issues can be obtained from the author at j.mills@leaseurope.org.

Effects of the approach envisaged by the IASB on lessees

Apart from the obvious increase in debt levels, the impact on gearing ratios and a lower return on assets, there will also be a P&L effect for operating lease users. EBIDTA measures will climb as lessees no longer recognise rental expenses. However earnings will fall as leasing costs are replaced by depreciation and interest which, under the current IASB approach, are likely to exceed rentals, particularly in the early years of a lease.