



## Article topic: Financial Reporting

# IASB Exposure Draft on Lease Accounting

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On 17 August 2010, the International Accounting Standards Board (IASB) issued an Exposure Draft (ED) to improve the accounting for leases. The IASB and the US Financial Accounting Standards Board (FASB) have been in collaboration to overhaul the current standards and no doubt the UK will follow suit.

### Existing requirements

Under the current IFRS regime, IAS 17 'Leases' and Topic 840 on leases in US GAAP requires the lessee to recognise an asset and associated liability where the lease is a finance lease. In contrast, the standard requires the lessee to charge lease payments against profit where the lease is classified as an operating lease. Classification as a finance or operating lease all depends on whether the risks and rewards of the asset's ownership has passed to the lessee (finance lease) or remains with the lessor (operating lease).

The UK's SSAP 21 'Accounting for Hire Purchase and Lease Contracts' takes the same stance.

### Proposed requirements

According to the IASB's ED, the current accounting requirements have been criticised because they do not provide a faithful representation of leasing transactions. Some critics have said the current accounting requirements can be engineered in such a way to achieve a desired outcome.

When the IASB introduce or amend existing IFRS they do so having regard to their 'Framework for the Preparation and Presentation of Financial Statements' (the Framework Document). According to the IASB Framework Document, the definition of an asset and liability is as follows:

*An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.*

*A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*

In revising the standards on leasing, the IASB and FASB have recognised that all leases, regardless of whether the risks and rewards of ownership have been passed to the lessee or not,

will give rise to an asset (a right to use the asset) and a liability (obligations to pay lease rentals for the right to use the asset).

### **'Right of use' model**

The current accounting requirements for leases have been criticised primarily because the current requirements allow manipulation of leases to achieve 'off balance sheet finance'.

The ED requires lessees and lessors to use a 'right-of-use' model in accounting for all leases. It should be noted that the ED does not deal with:

- Biological and intangible assets.
- Leases to explore for natural resources.
- The lease of some investment properties.

The ED will require a lessee to recognise an asset and an associated liability, regardless of whether (or not) the lease may previously have been recognised as an operating lease.

A lessor will recognise an asset to represent the future lease payments to be received from the lessee. The lessor should assess its exposure to risks or benefits and will then either:

- Recognise a liability under a 'performance obligation' approach, or
- Derecognise the rights in the underlying asset which it transfers to the lessee. The lessor will then continue to recognise a residual asset which will represent its rights to the underlying asset at the end of the lease term. This is referred to in the ED as the 'derecognition approach'.

The impact of the proposed new leasing standard on the financial statements would be felt less in respect of current leases which are treated as finance leases. However, entities who are reliant on operating leases as a source of finance will feel the effects more.

#### **Figure 1**

Company A operates in the haulage industry and leases a fleet of trucks from Company B. Company B retains the risks and rewards of ownership and therefore in accordance with IAS 17 the payments in respect of the lease are charged to the income statement on a straight line basis over the life of the lease.

Under the proposals in the ED, Company A will no longer charge the payments directly against profit. Instead an asset will be recognised in the balance sheet (statement of financial position) and an associated liability. The income statement (profit and loss account) will instead take the charges in respect of depreciation and finance costs in respect of the lease.

The proposed revisions to accounting for leases could have a detrimental impact on an entity who currently use operating leases as a significant source of finance, particularly in the current economic climate because the revised approach could result in lower asset turnover ratios, lower return on capital and have a detrimental impact on gearing ratios. For entities which have covenants in bank or other finance loans, this could result in such covenants being breached.

In contrast, earnings before interest, taxes, depreciation and amortisation (EBITDA) would be raised.

### **Measurement of assets and liabilities**

The ED states that assets and liabilities recognised by lessees and lessors should be measured on a basis which:

- Assumes the longest possible lease term, taking into consideration the effects of any options to extend or terminate the lease.
- Uses an 'expected outcome' technique in respect of the lease payments. Consideration must be given to contingent rentals as well as term option penalties and any residual value guarantees which are specified in the lease term.
- Is updated to take account of changes in facts or circumstances when such facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

#### **Figure 2**

Company A (who reports under IFRS) leases an item of plant from Company B. The fair value of the item of plant is £140,000 and lease payments are made monthly over a 5 year lease term. The present value of the minimum lease payments at the inception of the lease is £130,000. The residual value of the item of plant at the end of the lease term has been estimated as £15,000.

Company A will recognise an asset of £130,000, being the present value of the minimum lease payments. Company A will also record a liability at the lower of the fair value of the leased asset and the present value of the minimum lease payments. The difference between the minimum lease payments and the fair value (£10,000) will represent the present value of the residual value of the plant (£15,000).

### **Implementation**

The IASB have issued their ED which is now open for comment (comments close on 15 December 2010). The final standard is estimated to be issued in 2011 although implementation before 1 January 2013 is unlikely.

### **Conclusion**

Leases have always been problematic in the profession because of the scope to manipulate the concept of 'off balance sheet finance' and the proposal to treat leases as liabilities together with the corresponding 'right of use' asset is considered a significant change in the profession and one which standard setters in jurisdictions which do not currently adopt IFRS may consider.

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