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Leases

On-balance sheet – but at what cost?

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IN THE HEADLINES

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> “Bringing leases on-balance sheet is a cherished goal of the standard setters. These proposals would achieve that goal – but we question whether they will satisfy financial statement users, or justify the considerable cost and complexity of implementation.”
>
> – Wolfgang Laubach, KPMG’s global IFRS leases leader

A fundamental change in lease accounting

In a major shake-up of lease accounting, the IASB and FASB have published revised proposals to bring most leases on-balance sheet for lessees. Under the proposals, a dual model would be applied, based on a new lease classification test, which would determine the profile of lease income and expense recognised over the lease term.

The impacts would be felt across sectors. Companies that lease high-value assets – e.g. airlines and other transport companies – would see large increases in reported liabilities. Companies with large volumes of lower-value leases could face high implementation costs as they identify all leases and extract the data required to apply the new accounting models.

Major property lessees – e.g. retailers – would see a large increase in liabilities as property leases come on-balance sheet. Property companies, however, would see fewer accounting changes, because a version of current operating lease accounting would continue for lessors of property. A complex new accounting model would apply to non-property lessors.

Companies may seek to structure lease transactions in different ways. The current focus on whether a lease is an operating lease (off-balance sheet) or a finance lease (on-balance sheet) would be irrelevant. Instead, companies might focus more on whether a contract is a service arrangement (off-balance sheet) or a lease (on-balance sheet).

Identifying leases and extracting lease data

Companies would need to identify all lease agreements as defined by the proposed standard and extract all relevant lease data – including details of any renewal and purchase options – from such agreements, in order to:

- determine whether the simplified model for short-term leases can be applied;
- establish the most appropriate accounting model for leases longer than 12 months; and
- measure the amount of assets and liabilities to be recognised.

These efforts could be time-consuming and costly.

Changes in key financial metrics

Key financial metrics would be affected by the recognition of new assets and liabilities, and by changes in the profile and presentation of lease income and expense. There could also be impacts on:

- compliance with debt covenants;
- employee compensation arrangements;
- tax balances; and
- the company’s ability to pay dividends.

A key consideration for many corporates is whether such items would be determined with reference to ‘frozen GAAP’ – i.e. current IFRS – or would be affected directly by the adoption of new accounting standards. Banks would also be concerned about the effect on regulatory capital.

New estimates and judgements

New estimates and judgements would be required to identify, classify and measure leases – including:

- new criteria to determine when an arrangement contains a lease;
- a new lease classification test, based on the nature of the asset and the extent to which the asset is consumed over the lease term; and
- new thresholds to determine whether renewal periods are included in the lease accounting.

The impact of the proposals would depend materially on these estimates and judgements. Companies would need to collate extra information and ensure that senior staff are involved in preparing and reviewing the lease accounting.

Balance sheet volatility

Key judgements would need to be revisited at the end of each reporting period. A company would no longer be able to agree a lease amortisation schedule on lease commencement and roll that schedule forward at the end of each reporting period. Instead, they would need to reassess key judgements, and consider the need to remeasure lease balances each time they report.

For example, companies would need to reassess their initial judgements and estimates regarding:

- the lease term;
- the discount rate used; and
- variable lease payments.

Remeasurements during the lease term would provide more up-to-date information to users of financial statements, but would introduce new volatility into the balance sheet. This would affect a company's ability to accurately forecast its results and future balance sheet.

Changes in contract terms and business practices

Lease length and renewal options may become key considerations, with companies possibly entering into shorter leases to reduce their reported lease liabilities. Some may enter into very short leases to take advantage of the continued off-balance sheet treatment of short-term leases – i.e. those with a maximum contractual term, including renewal options, of 12 months or less.

In some cases, companies might reconsider buy vs lease decisions. And the attractiveness of sale-and-leaseback transactions as a source of finance may decline, given that such transactions would be on-balance sheet for the seller/lessee.

New systems and processes

Systems changes may be necessary to identify leases and extract the requisite data in compliance with the proposed requirements. In particular, companies would need a complete inventory of all leases in place for transition.

Processes would also need to be reconsidered, to ensure that management judgement is exercised at critical junctures in the preparation of financial information. The complexity, judgement and continuous reassessment requirements may require additional training, and senior staff may need to provide more input.

Communication with stakeholders will require careful consideration

Investors and other stakeholders will want to understand the impact of the proposals on the business. At present, many users of financial statements make adjustments to include the effect of off-balance sheet lease accounting in their analysis. A key consideration will be whether the specific adjustments proposed by the new standard would match those currently made by users, and whether any differences can be clearly explained.

However, given that the proposals will remain under consultation until September 2013, the timeliness, content and cost-effectiveness of any analysis will require careful consideration.

This is the time to look at your lease contracts

Does your company have the information and processes needed to implement these proposals? If not, now is the time to start looking at the effect of these proposals on your lease agreements – both current and future.

For more information on the proposals, please go to the IASB press release or speak to your usual KPMG contact.

> "Implementing these proposals would be a real challenge for many organisations, as they would need to identify all their leases, extract key data, make new estimates and judgements, and implement new or updated systems to perform the required calculations."

– John McGaw,
KPMG's leasing standard implementation leader

Basic facts

ED/2013/6 *Leases* was issued by the IASB and the FASB on 16 May 2013. This exposure draft (the ED) is the latest stage of the Boards' joint project to introduce a new approach to lease accounting that would require assets and liabilities arising from leases to be recognised in the balance sheet.

The proposed standard would replace IAS 17 *Leases* and related interpretations. The proposals would also amend IAS 40 *Investment Property*, requiring the lessee to apply IAS 40 if the leased property is investment property.

The ED sets out a revised version of the proposals included in the 2010 exposure draft *Leases*. It proposes that entities could apply the new standard retrospectively, or follow a modified retrospective approach.

The comment period ends on 13 September 2013. The ED does not propose a specific effective date for the final standard.

Timeline

16 May 2013:
ED published and comment period begins

13 September 2013:
Comment period ends for the ED

Not established:
Earliest date of adoption

Not established:
Earliest annual financial statements for which the proposals would apply

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