Lease accounting: Bygone days of off-balance sheet financing?

Nearly three decades on, the dream of putting all leases onto lessees' balance sheets could soon become a reality, if the International Accounting Standards Board (IASB) has its way.

By the staff of the Singapore Accounting Standards Council (ASC)

The IASB, together with the US Financial Accounting Standards Board (FASB), recently issued the much anticipated revised exposure draft (ED) to reform lease accounting. The proposal, which promises to provide better insight into lessees' leverage and lessors' exposure to risks, could affect entities across industries.

Preliminary reactions on the ground are mixed – some welcome this overdue reform, whilst others naturally worry about heavier balance sheets and big implementation costs.

What does the revised ED propose?

The proposal is based on a dual lease model and includes approaches similar to today's finance leases of lessees and operating leases of lessors. However, the similarities end here.

Under the proposal, the accounting approach is expected to differ between property and non-property leases – a lot more non-property leases would be accounted for as financing arrangements. For example, a 10-year lease of a vessel with a useful life of 40 years would be treated as a financing transaction. Replace the vessel with a building having the same remaining useful life and the outcome would be vastly different.

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1. For lessees

Notably, lessee accounting would be most impacted. Lessees would recognise lease liabilities and corresponding assets, representing rights to use leased assets, on the balance sheet for all leases, property or otherwise, with a maximum term – including renewal options – exceeding 12 months. Short of a default, a lessee cannot avoid payments once it takes delivery of the leased asset.

In the income statement, lessees would recognise a straight-line expense for most property leases, similar to current operating leases. However, a retailer that leases a retail space for three years, for instance, would have to reassess lease payments that are pegged to an inflation or other indices and record rental expenses that fluctuate year on year.

In contrast, lessees of most non-property leases would recognise more expenses in earlier years, just like any asset purchase that is financed by debt. An airline with a fleet of new aircraft would record similar expense, whether the new fleet is leased on a five-year term or is purchased on credit.

2. For lessors

Lessors of most non-property leases would follow an approach that is a variant of current finance lease accounting. For example, an equipment dealer that enters into a three-year lease on an equipment ceases to have control of that asset upon delivery. The equipment would be de-recognised and replaced not just by a lease receivable, but also another asset representing the right to recover the equipment at the end of the lease. The variant approach is expected to be more complex than current accounting, due to the separate accounting for this right of recovery.

Lessors of most property leases would keep their current operating lease accounting. The financials of commercial and retail building owners would be largely unchanged – investment properties and rental income that reflects how rental yields are determined would stay for years to come.

Why are changes necessary?

The current lease accounting has been heavily criticised for taking many leasing transactions off balance sheets, obscuring the real extent of leverage and creating structuring opportunities around arbitrary bright lines. In fact, some of these off-balance sheet financing are very substantial.

The former IASB Chairman, Sir David Tweedie, a champion for the reform of lease accounting in the past decade, has famously remarked: "No-one in the room has ever flown on an airplane that appeared on the airline's balance sheet."

The IASB set forth to put an end to off-balance sheet financing but its first joint ED with the FASB in 2010 met with considerable resistance. Fast forward three years and the IASB continues to face an uphill task in convincing entities to put all leases onto balance sheets.

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What is the controversy about?

The controversy lies herein. The global financial crisis, caused partly by excessive risk taking and leverage, amplified the need to end off-balance sheet accounting and appropriately reflect risks in financial statements.

The current IASB Chairman, Mr Hans Hoogervorst, has aptly described: "If this financing were in the form of a loan to purchase an asset, then it would be recorded. Call it a lease and miraculously it does not show up in your books."

Yet, the fact remains that some quarters in the largest economies continue to lobby against recognising all lease liabilities. They contend that re-leveraging defeats the business objective of leasing and could mark an end to the leasing industry.

Critics counter that these concerns are exaggerated as investors, analysts and others already adjust key financial ratios for off-balance sheet financing today, albeit based on an educated guess using existing leasing disclosures. Putting them onto balance sheets would not significantly impact how one views the financial health of affected entities.

Some further see the proposal as a compromise to the IASB's original thinking – all leases are financing arrangements and should be accounted for using a single lessee model – to boost acceptance by the leasing community.

Even proponents who support the recognition of leased assets that are core to operations may be hard-pressed to appreciate the information value of putting other leased assets, such as photocopiers, onto balance sheets.

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No doubt, lessees' balance sheets would be heavier carrying both sides of the lease equation. Prima facie, key financial ratios such as gearing, capital adequacy, returns on assets and potentially debt covenants would be affected.

In reality, the impact may well just be creating awareness amongst financial statement users on an accounting outcome that merely reflects, in more accurate terms, today's adjustments to key financial ratios.

Although the current lessor accounting has largely been spared from criticism, the IASB believes that retaining it would be inconsistent with the new lessee accounting.

Some may view the proposed changes to lessor accounting with apprehension as they do not consider the current accounting to be broken. However, one cannot deny that lessors' rights and lessees' obligations are two sides of the same coin. A fundamental rethink of lessee accounting would trigger consequential changes to lessor accounting.

What's next?

The reform of lease accounting, a project that spans over almost a decade and has sparked considerable debate globally, is clearly challenging and controversial. Entities should pay particular attention to avoid being caught off-guard when the proposal crystallises in its current form.

The fact that the IASB and FASB have gone from their current dual lease model to a single lease model in the first ED, and reversing their position in the revised ED, is probably as much a reflection of the technical complexities as a calculated compromise to achieve improved financial reporting.

Perhaps, the foremost question to be considered is: *Does the proposal significantly improve financial reporting, considering its implementation and ongoing compliance costs?*

Yet, any debate on the merits of the proposal could be futile without first tackling this fundamental question: *Do all leases contain a financing component that warrants the same accounting as any other financing arrangements?*

The debate does not end here – the IASB and FASB would start their joint re-deliberation after the comment period for the revised ED ends this September.

The proposal is a commendable step towards improving financial reporting but the devil is in the details. Stakeholders are encouraged to evaluate the proposal and provide feedback to the ASC, and in so doing, contribute towards improved financial reporting.

Comments should reach the ASC at MOF_Feedback_ASC@mof.gov.sg by 15 August 2013.