Lease accounting

A ROUNDTABLE HELD BY ACCA AND THE FINANCE & LEASING ASSOCIATION (FLA)

MARCH 2015

In March 2015, ACCA and FLA held a joint roundtable seminar, hosted by FLA, to discuss the probable content of the revised International Financial Reporting Standard on leasing, and the implications for the leasing industry and the preparers of financial statements. This briefing paper summarises the discussion.

ABOUT FLA

The Finance & Leasing Association (FLA) is the leading trade association for the consumer credit, motor finance and asset finance sectors. Its members include banks and building societies and their subsidiaries, the finance arms of leading retailers and manufacturing companies, and a range of independent firms. In 2014, FLA members provided over £99.5 billion of new finance to UK businesses and households. Of this, £25.4 billion was provided to businesses and the public sector to support investment in new equipment, representing almost 27% of the investment in machinery, equipment and purchased software in the UK last year.

ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management. We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of 92 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting, and conduct relevant research to ensure that accountancy continues to grow in reputation and influence.

FOR MORE INFORMATION CONTACT

Simon Goldie
Head of Asset Finance, FLA
simon.goldie@fla.org.uk

Richard Martin
Head of Corporate Reporting, ACCA
Richard.martin@accaglobal.com

Introduction

In 2006, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began working towards a new, common set of international lease accounting standards. The resulting proposals were expected to cover both lessors (the firms providing the finance for a leased asset) and lessees (the businesses seeking finance for a leased asset).

At the time of the roundtable in March 2015, the IASB was about to consider the final version of the revised leasing Standard, with approval by the Board anticipated within the month and a new Standard announced at the end of 2015. The IASB publishes details of its deliberations and decisions, and the overall revised leasing model is now becoming apparent. The lessor accounting model will remain the same as it is now. Under the revised Standard a single model will apply to lessees, with balance sheet recognition reflecting the right of use (RoU) of the leased asset.

Throughout this project to replace the existing Standard IAS 17, the RoU methodology has been proposed for lessees. Its supporters point to the more accurate reflection of the financing element of a lease arrangement this gives in the accounts, in accordance with the provisions of the IASB's Conceptual Framework. Others have expressed concerns about increased accounting complexity, and the adverse impact on compliance with bank covenants. A key reason for holding the roundtable was to discuss the effect of such complexity on the leasing industry and its customers, and how this will, or can be, addressed.

1. Key considerations arising from the current proposals

'SMALL TICKET' EXEMPTION

Leased items with a value, when new, of less than US$5,000 (a figure considered reasonable, but which is not fixed) will be exempt from RoU accounting, and the lease payments will instead be expensed. If the total of an entity's 'small ticket' items is over its 'materiality limit' (which is the amount that has an impact on its financial statements overall), the exemption will nonetheless apply. In practice, this situation is not expected to arise frequently.

The 'small ticket' exemption is intended to be a practical solution, especially for organisations with a large number of such items, which would therefore otherwise be disproportionately affected by the revised leasing Standard.

SUBSTITUTABILITY

This is one of the main factors to consider when determining whether an arrangement involves a lease. Broadly, an asset over which the supplier retains a right of substitution is subject to a service contract, rather than a lease. The supplier's right must be a 'substantive' one, which means that the ability to substitute should be of practical and economic benefit for the supplier.

This is a key issue for the suppliers of vehicles, who will not benefit from the 'small ticket' exemption above with respect to most of the vehicles supplied. In understanding the concept of substitutability, it may help to consider the main attribute indicating that it does not exist in practice: the customer has the exclusive use of a specific asset, and consequently controls it. This exclusivity is unaffected by the supplier's ability to substitute in occasional and unavoidable circumstances, such as when a car needs repair.

This control was evident in many past company car arrangements, when the employee was given a 'perk', even choosing the make and model, and regarding the vehicle as his/her 'own' during the primary lease period. Modern businesses increasingly require flexibility, however, such as sharing arrangements that maximise the chance that a vehicle will not be idle while with them. Equally, the customer's need for flexibility may require it to secure the right to substitute one vehicle for another, in response to an immediate business need. The right of substitution, by itself, implies the existence of a leasing arrangement, but the customer's control has to be over an identified asset.

The IASB is encouraging companies in the leasing industry to send to it examples of such situations, to assist the IASB's understanding of this arrangement.

The component parts of larger assets (such as batteries and engines) can be subject to their own lease agreements, but this should not detract from the overall purpose of the arrangement involving the larger asset. For example, throughout the course of a lease, a passenger airline may need an aircraft to be of a specific capacity, and to be able to decide where it is located, and the routes on which it is flown. Consequently, although certain components are substitutable, the aircraft as a whole will not be.

SHORT-TERM ARRANGEMENTS

Where an arrangement is for 12 months or less, it will not be accounted for under the RoU model. Roundtable participants expressed concern that a 'rolling' arrangement, which, in the end, runs for more than one year, would have to be treated as a lease within the scope of the revised Standard.

There should, however, be no danger of arrangements being 'caught' in this way. Where the customer has a genuine need for flexibility, the arrangement will have a non-cancellable period (if any) of much less than 12 months. Consequently, it will not have to be accounted for under the RoU model.

2. Local and regional impact, and the IFRS for SMEs

EUROPE

Unsurprisingly, participants discussed the endorsement process used by the European Financial Reporting Advisory Group (EFRAG), as this will apply the revised leasing Standard to EU-based reporting companies.

It was noted that varying views were expressed during EFRAG's own outreach, although they broadly supported the IASB model of one lease type for lessees.

EFRAG's endorsement process has to consider a number of criteria, such as the public good. It is believed that this includes the economic impact of any change to the Standard.

For the revised leasing Standard, as for other Standards, early engagement between EFRAG and all interested parties (such as preparers, the IASB and external auditors) is to be encouraged. This should, as far as possible, reduce points of contention and other delays in the endorsement process.

UK GAAP AND THE IFRS FOR SMES

Participants noted that most UK entities still adopt national GAAP for their financial statements. That means it is unclear when the revised international Standard on leasing will have an impact. Once the international Standard is issued and endorsed by EFRAG for use in Europe, it will need to be considered for incorporation into Financial Reporting Standard (FRS) 102 for the UK and Ireland by the Financial Reporting Council (FRC), either as a stand-alone amendment, or as part of a general revision to FRS 102 that is due about 2018.

FRS 102 is based on the IASB's International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). This Standard is reviewed about once every three years, and the last review was initiated for comment in 2012. The IFRS for SMEs is now unlikely to be updated to reflect changes to 'full IFRS' until they have been implemented. In the case of leasing, there will consequently be a period during which the IFRS for SMEs diverges from 'full IFRS'. Furthermore, revisions to the IFRS for SMEs will be considered in the light of the particular information needs of SMEs.

The FRC does not, however, need to await a revised IFRS for SMEs before making changes to UK GAAP. Furthermore, the FRC is able to depart from the provisions of the IFRS for SMEs in cases where it is aware that to do so would be more relevant for preparers in the UK and Ireland.

3. Due process

The revisions to the Standard on leasing have already been the subject of one Discussion Paper, and two Exposure Drafts (EDs) of a proposed Standard. The IASB's intention, as outlined at the seminar, is to issue an explanatory paper (see below), and then make a limited circulation of the revised Standard for the purpose of the usual 'fatal flaw' review. A further formal consultation is not planned before the final Standard is issued, with a probable effective date of the start of 2018.

When determining whether and how views should be requested once again, there are a number of factors to bear in mind.

Changes have been made since the second ED, for example, the exemption for 'small ticket items', and the differing models now proposed by the IASB and the FASB in the US.

The basic principle remains that the RoU model applies to all leases, unless covered by an exemption. Throughout the project, the IASB's intention has always been to overhaul the IAS 17 model of operating and finance leases, replacing it with a model regarded as more realistic by many users of the financial statements.

The extent of consultation already undertaken since the second ED, for example at outreach events, and the detail of discussions available in published IASB papers.

The time and resources involved in issuing a third ED, in the light of what could still be learned from respondents, and the resource needs of other projects in the IASB's work plan.

Increased awareness of the proposals would result from a third ED, especially if it makes clear the reduced burden for preparers compared with that imposed by the second ED, and if accompanied by a cost-benefit analysis.

The IASB has now issued the explanatory paper setting out the possible effects of applying the intended revised Standard, and comparing it with the FASB's proposals The paper aims to address questions already raised with the IASB: it is not expected to give rise to further questions.

4. Recommendations and conclusion

RECOMMENDATIONS

ACCA and FLA welcome the proposed ‘small ticket’ exemption above, but each body has some further recommendations, as follows.

FLA

The exemption should be widened to ensure that it captures all small-ticket funding arrangements.

The test for substitution should be set at a low level to ensure that business practice is reflected in the proposed Standard.

FLA continues to have concerns over the negative impact that the proposed changes may have on lessees, and urges the IASB to consider a further consultation before announcing the final Standard.

ACCA

In view of the likelihood that the revised Standard will adopt the RoU model, it may be that at this stage it would be of greater benefit to consider other matters.

Firstly, there is the question of the sufficiency of the proposed exemptions from RoU accounting, bearing in mind that these are founded on practical considerations, rather than being conceptually based, which implies that there is a limited scope for granting exemptions.

Secondly, it is worth considering whether the revised leasing Standard fully covers the much more flexible arrangements required nowadays by the customers of leasing companies. As noted above, the IASB would welcome examples that illustrate the concerns for the leasing industry, such as how modern leasing agreements deal with the substitutability of assets, uncertainties over where the boundary lies between a lease and a service contract, and comments on the IASB’s recent ‘effects paper’ mentioned above.

ACCA agrees that there is a case for the IASB to issue a final Exposure by the IASB of the revised Standard, in view of the changes made since the last consultation, and the Standard’s very widespread impact. This would at least demonstrate that all voices have had the opportunity to be heard on these changes.

Conclusion

The leasing industry's main concerns about the revised leasing Standard relate to the accounting effects of the capitalisation of all leases (unless exempt), and the administration costs that will be imposed on the industry's clients when preparing their financial statements.

It is debateable whether or not there is an increasing acceptance within the industry of the RoU model, and its balance sheet effect of making leases more akin to a financed purchase than an expensed rental. Nonetheless, there are clear signs that the RoU model will be adopted, as the IASB, and indeed, a number of other parties, regard it as the most appropriate solution.

The IASB's work and publications

The IASB's Disclosure Initiative focuses on the quality of disclosures in published financial statements. In the same spirit, the revised Standard on leasing will seek to distinguish minimum (compulsory) disclosures, and additional ones to be made according to their assessed significance.

The more appropriate general accounting principles, which should eventually result from the Disclosure Initiative, will assist in implementing the revised leasing Standard, such as the application of discounting techniques to leasing balances only if their effect is material.

Although the revised Standard on leasing is intended to be comprehensive, in a minority of cases it may be necessary to look to another IFRS. For example, while the matter of sale and leaseback is covered in the revised leasing Standard, reference will have to be made to IFRS 15 Revenue from Contracts with Customers, if the arrangement contains an embedded repurchase option.

ACCA PUBLICATIONS ON THE LEASING PROJECT

Lease Accounting: An Update on the International Proposed Amendments (June 2014), <http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2014/june/lease-accounting-an-update.html>, accessed 3 June 2015.

The International Project on Lease Accounting: The View from Europe (January 2015), <http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2015/january/the-international-project-on-lease-accounting.html>, accessed 3 June 2015.