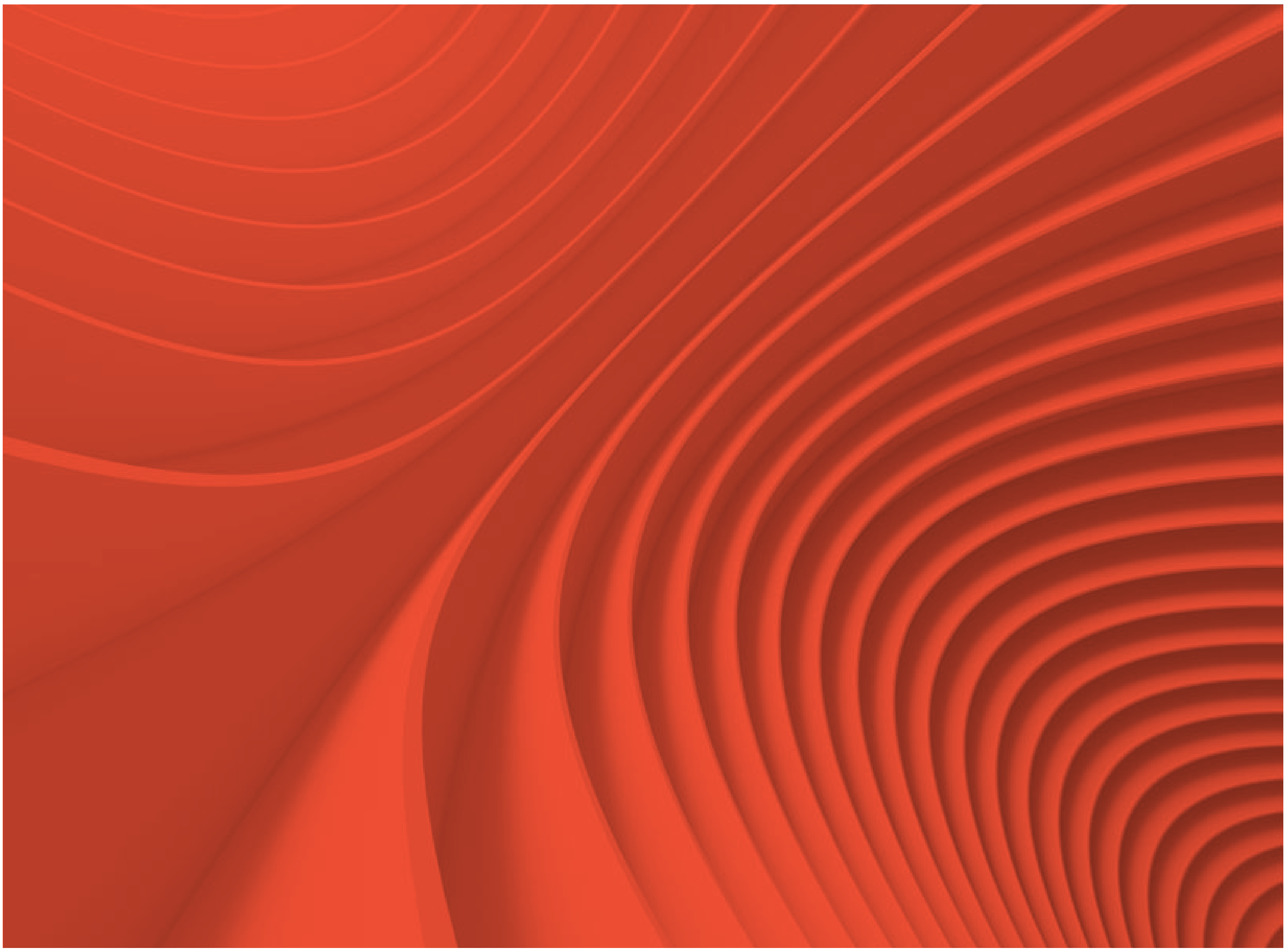
Lease accounting: an update on the international proposed amendments



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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.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 162,000 members and 428,000 students in 173 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 91 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

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Global Forum for Corporate Reporting
The Forum's role is to Influence the development of financial and non-financial reporting around the world. It aims to identify and evaluate the various ways in which corporate reporting can add value to investors, businesses and the public. It also addresses the issues and challenges that surround the adoption of international financial reporting standards around the world.

This paper describes the development of the IASB/FASB project on lease accounting launched in 2009, its current proposals, and ACCA's views on these.

The international amendments to lease accounting, once final, are likely to have a significant impact on lessees, in particular. The proposed amendments seek to address long-standing criticisms of the current lease accounting model.

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1. Introduction

This paper describes the development of the International Accounting Standards Board (IASB)/Financial Accounting Standards Board (FASB) project on leasing, the current proposals, and ACCA's views on these.

The project's aim is to address criticisms of the current International Accounting Standard on leasing, IAS 17. In particular, there are concerns that numerous leases are not reflected on balance sheets, despite their clear financing element. As a result analysts, in particular, have made their own adjustments, with the consequent risk of inconsistency.

Accounting Standards do need to address the above situation. Throughout, the proposed solution has been to include the large majority of leases on the balance sheets of both lessees and lessors. By contrast, IAS 17 sets a high threshold below which lease payments can be expensed by lessees. The resulting simpler and usually more tax-beneficial treatment presents a risk that leases will be manipulated to meet the criteria for expensing.

IAS 17 has been criticised for not reflecting economic reality. Well-known examples include fleets of aircraft or rolling stock that do not meet the criteria for recognition as assets and liabilities by the lessee, and for which a lack of detailed disclosure is required in financial statements.

The project on leasing is long running, generating numerous responses, some expressing support for change but others preferring to leave the IAS 17 model fundamentally unaltered. Understandably then, the proposals have been amended over time, although some changes give an impression of compromise.

ACCA has engaged in the consultation throughout, developing views through the ACCA Global Forum for Corporate Reporting (and its predecessor, the ACCA Financial Reporting Committee). ACCA agrees that, to a greater extent than at present, the financing element of leases should be reflected on the balance sheet. Nonetheless, given concerns about the proposals, ACCA's stance remains markedly different to that of both the IASB and the FASB (as full convergence now appears unlikely).

2. Background to the development of the leasing project

The leasing project has been undertaken by the IASB and the US standard-setter, the FASB. ACCA has provided its comments through the IASB. As explained in the Appendix, it now appears unlikely that a fully converged new Standard on leasing will be issued by the two Boards.

THE CURRENT STANDARD

The aim of the leasing project is to create a replacement for IAS17, which currently distinguishes between two types of lease. A finance lease transfers to the lessee 'substantially all the risks and rewards incidental to ownership of an asset'. IAS 17 provides guidance on the indicators that a finance lease exists. Any other lease is an operating lease. Finance lessees recognise an asset and liability in the balance sheet as if they have purchased the asset (the 'purchase in substance' approach). The lessor recognises the net investment in the lease as an asset.

Where there is an operating lease, the asset is recognised by the lessor as if it is not leased out, and no asset or liability is recognised by the lessee. Lease payments are recognised as income by the lessor and expenses by the lessee, usually on a straight-line basis. Lessees make a limited number of disclosures – principally, an analysis of the total lease commitments at the balance sheet date.

THE 2009 DISCUSSION PAPER (DP)

'Right of Use' model

The IASB began the consultation phase of the project with the publication of a DP in 2009. This proposed a 'Right of Use' (RoU) model for leasing (as opposed to the 'purchase in substance' approach under IAS 17). The IASB continues to support the RoU model in its proposals. A consequence of this is that the effect of the changes proposed would be greater for lessees than for lessors.

The 2009 DP dealt mainly with the accounting by lessees, and proposed the capitalisation of an asset and liability for the majority of leases in the lessee's balance sheet. As explained in the section below on the 2013 Exposure Draft, the asset on the balance sheet of the lessee would reflect not the cost or fair value of the leased asset, but the right to use it.

This step change from the current IAS 17 requirements may be welcomed by analysts for the information it would provide. The new treatments would, however, have clear compliance implications for preparers with numerous leases, which currently qualify as the operating type under IAS 17. These preparers are likely to be concerned about the amount of work that would be involved to reflect these leases on the balance sheet under the RoU model in relation to the relevance of the new accounting treatment. This raises the question of how justifiable it would be to replace the current IAS 17 treatments with the RoU model.

Other matters

The DP also proposed certain exceptions from the scope of a new Standard based on the RoU method: for example, short-term leases. These exceptions have been subject to alterations as the leasing project has developed.

Finally, the project on leasing has, throughout, not considered the leasing of intangible assets as well as tangibles.

THE MAIN CONSIDERATIONS ARISING FROM THE PROJECT

Developments through to the current (2013 ED) proposals described below can be assessed in the light of the following considerations.

Is a provision or an exception justifiable in accounting terms? For example, are any asset-recognition requirements questionable on a conceptual basis? Does a particular simplification give the impression that its main purpose is to make the RoU model more workable in practice?

What is the effect on the compliance burden for preparers? Ideally, a new Standard on leasing would avoid undue complexity and, where possible, would address areas that will cause particular difficulty for preparers.

Do the proposals keep to a minimum the areas of uncertainty requiring judgement? Typically, the greater the need for judgement, the higher the risk of diversity in practice (for example, the risk that the same lease will be accounted for differently by the lessor and the lessee), and the greater the compliance burden (owing to the time involved in making judgements).

In fact, these considerations could also be applied to proposals in areas other than leasing.

THE 2010 EXPOSURE DRAFT (ED)

The first Exposure Draft (ED) of a proposed new Standard was issued in 2010. The proposals included, as one of two possible scenarios, the Performance Obligation Model. This involved a double-counting of assets by lessors (in which each asset is recognised both as a tangible fixed asset, and as an asset for the rentals receivable plus residual value). This proposal was not, however, pursued.

Complexity for users is likely to have arisen from the 2010 ED's requirement that probabilities be applied to the question of whether optional lease extensions should be recognised. In addition, the proposed recognition of most contingent rentals entailed the risk of recognising liabilities that do not, in fact exist. There have been attempts to address these concerns through subsequent changes in the IASB's proposals.

3. The current proposed amendments

THE 2013 ED

In May 2013, the IASB issued a revised ED, for which the comment period ended on 13 September 2013. Fundamental to this ED is the distinction between two types of leases – Type A (where the lessee consumes most of the asset during the lease term), and Type B (the opposing scenario, usually applicable to leases of property).

For lessees, both types of lease would result in the recognition of an RoU asset and liability, measured at the present value of lease payments. There are two expenses – the amortisation of the asset, and the unwinding of the discount on the lease liability. In the case of Type B leases, the 2013 ED proposes that the total expense is presented as one cost in the profit and loss account, calculated to be the same amount over each year of the lease term.

While the above 'straight-line' total presentation for lessees would look quite familiar to current operating lessees, it might be questioned whether this profit and loss account treatment constitutes a justifiable compromise, in view of the treatment required in the balance sheet. It is now no longer being proposed by the IASB.

Lessors would experience fewer changes to the current requirements under IAS 17. For Type A leases, the underlying asset would be de-recognised, and in its place, assets would be recognised that represent the rights to receive payments and the residual rights in the asset. Type B lessors would continue to recognise the underlying asset, and would recognise payments from the lessee as income on a straight-line basis.

Exceptions to the current proposals include short-term leases, once again (a simple straight-line basis through profit and loss can be adopted), and arrangements that do not meet the definition of a lease, such as those for assets for which another can easily be substituted.

For example, a standard office copier can be readily replaced with another of the same model (in contrast to, say, a custom-made piece of machinery). The rental agreement is consequently most unlikely to constitute a lease, and hence the copier would not be subject to the greater complexity of RoU accounting.

The 2013 ED does address some of the areas of concern arising from the 2010 ED, and that were noted above. Nonetheless, it still leaves room for judgement through the use of words such as 'insignificant' in the criteria for how a lease should be recognised, and 'significant economic incentive' in considering whether an optional period should be included in the lease term recognised. An alternative, supported by ACCA, was for no recognition of optional extension periods, but for disclosures to be made about the options. As set out in the Appendix below, some further re-consideration has now taken place by the IASB and FASB.

The need to spend additional time making such judgements will not be welcomed by preparers, particularly those with numerous operating leases who would already face an increase in compliance costs when having to adopt the RoU methodology.

4. ACCA's position on the proposed amendments

GENERAL ASPECTS

Throughout, ACCA has expressed concerns about the application of the RoU model to the large majority of leases. The IASB's proposals do have the effect of bringing more assets and liabilities onto the balance sheet of lessees than is currently the case, which partly solves the problem that some leases with a financing element do remain 'off balance sheet'. Nonetheless, it is also important to avoid either unnecessary complexity or wording that leaves scope for uncertain judgements, including over whether liabilities and assets can be validly recognised.

ACCA has consequently challenged proposals that may arguably lead to uncertainty or an undue compliance burden, or where the accounting logic raises questions, such as the areas of concern set out above with regard to the 2010 ED.

It would be helpful if the project had covered, from the outset, the leases of intangible assets, as well as tangibles.

ACCA'S POSITION IN RESPONSE TO THE 2013 ED

The 2013 ED does represent improvements in clarity when determining whether a lease, rather than a service agreement, exists and, if it does, whether the lease is short-term (and so can apply a simplified accounting treatment).

Even so, ACCA still remains unable to support an RoU method for leasing, in spite of the extensive work undertaken by the IASB in its attempt to establish a workable model which reflects economic reality.

Some concerns about complexity and the need for judgements are described above. Other concerns, with respect to the proposals in the 2013 ED, include the impression that the 'straight-line' accounting proposed for Type B leases represents an element of compromise that is not fully justifiable in accounting terms.

At this stage, it is now time to look for improvements to the current model under IAS 17, without changing it fundamentally. In particular, a reduction is needed in the number of arrangements that can qualify as operating leases, and so can remain off the lessee's balance sheet. Meanwhile, for those leases that do still qualify as operating (for example, owing to their minimal financing element), the identified inadequacies in information for users need to be addressed.

The IASB might begin the process of improving IAS 17 by addressing two relatively straightforward questions.

How far should the current dividing line between financing and operating leases be moved, in order to bring on to the balance sheet more leases with a financing element?

For operating leases, what additional disclosures would be relevant and useful compared with the few, summary disclosures currently required by IAS 17?

ACCA'S PREVIOUSLY PUBLISHED COMMENTS ON THE 2013 ED

Video presentation
http://www.youtube.com/watch?v=GlbyeUhX998 <http://www.youtube.com/watch?v=GlbyeUhX998>.

Press release
'ACCA global forum calls for IASB to abandon planned new Standard on leasing', 13 September 2013 <http://www.accaglobal.com/uk/en/press/lease-iasb.html?from=XX <http://www.accaglobal.com/uk/en/press/lease-iasb.html?from=XX>.

Article
'Lease Alert', *AB International,* <http://issuu.com/accaglobal_publications/docs/ab_int_sept13_comp_rgb_150 <http://issuu.com/accaglobal_publications/docs/ab_int_sept13_comp_rgb_150> (page 57).

Appendix: further deliberations by the IASB and FASB

In January and March 2014, the IASB and FASB re-considered their proposals, in the light of the responses received to the 2013 ED. Currently, the IASB now envisages for all lessees a single (Type A) model, while FASB plans to retain the Type A/ Type B distinction. The two boards are more in agreement on lessor accounting, for which the proposed Type A/B distinction will remain, though this distinction will now be more closely based on the finance versus operating lease model in the existing IAS 17.

A number of practical relaxations and clarifications are now also proposed, mostly by both Boards jointly. These should help to address concerns expressed by respondents about the costs of implementing a new Standard. For example, the accounting for an option to extend a lease will be subject to the criterion of the extension being 'reasonably certain', as included in the current IAS 17, rather than the less clear rationale of a 'significant economic incentive' proposed in the 2013 ED. The relief from lease accounting requirements for many 'small ticket' items will also be welcomed by preparers.

Currently, the way forward is becoming clearer, including as regards the key change whereby most leases will be included on the balance sheet in future. Nonetheless, the lack of consensus among interested parties, including the IASB and FASB, still presents difficulties for the leasing project, as compared with another major joint endeavour for the IASB and FASB – revenue recognition. For this project, greater convergence has been possible between the two Boards, and a new Standard has now been issued.

For leasing, the IASB website shows that re-deliberations took place in the second quarter of 2014. There are no indications that further formal consultation is envisaged, for example the issue of a third ED for public comment.

The final new International Standard is now unlikely to be fully converged with the corresponding US requirements, though a number of commentators expect that it will be issued as soon as next year, with an effective date of 2018. A less favourable outcome would be the issue of an interim Standard, which would be especially unhelpful in the case of longer-term items as many leases are. Furthermore, while intended to be a temporary solution, interim Standards can stay in force for longer than planned, as they bring with them a risk of reducing the impetus for a producing a suitable, final new Standard.

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