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Leasing - A New Approach?

Introduction

Lease accounting has, historically, been slow to follow the general principles of accounting, including those relating to accounting for assets and liabilities. When attempts have been made to modernise that accounting, they have been invariably been controversial, particularly among preparers and in the leasing industry. This is hardly surprising. Disturbing the accounting for trillions of dollars is never likely to be popular.

The IASB is currently trying to take lease accounting forward to what many would see as new ground. They are endeavouring to introduce a model which focuses upon the rights being transferred from a lessor to a lessee as the asset in question and the obligation of the lessee to repay the lessor as the liability[1]. This approach, conceptually, would treat all leases in the same way[2].

The proposed change is being accompanied by controversy, and, as in the past, criticisms often accentuate complexity, cost and/or potential impacts on leasing businesses, as well as indirect costs that might, for example, come from renegotiating trust deeds that contain accounting based benchmarks for borrowing or other purposes. Further complications are coming from leasing being a convergence project in which the IASB and FASB are seeking to come to the same answer.

Is lease accounting really so inherently difficult?

In concept, lease accounting is quite simple and the basic economics are familiar to any person running a business or not-for-profit entity. Rights to use are passed to lessees from lessors in return for a margin. Leasing is just one means of financing the obtaining of the asset, often with some tax advantages through the deductibility of rentals.

Lessors have receivables similar to a bank that lends on a mortgage. As repayments are made the receivables reduce and interest income is recognised.

Lessees have, as an asset, the rights subject to the lease and an obligation to make lease payments. As they use up the asset, they recognise depreciation/amortisation and as they repay their obligations they reduce their liability and recognise interest expense. This is much like repaying a bank for a mortgage on a purchased depreciable fixed asset.

How has lease accounting lagged behind general accounting principles?

The first international standard was issued in 1982 and was based on similar standards issued in 1976 in the US[3]. A few countries (e.g. Australia, Canada and the UK) had similar standards by the early 1980s, mostly also derived from the US standards.

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1 Though if one looks at the literature from the late 1970s the notions of “rights to use” and “obligations to pay” were common.
2 I will come back to possible exceptions to the principle being considered by the IASB later in the paper.
3 IAS 17 was based on FAS 13, as were the other domestic standards.

Prior to these standards, leases were generally accounted for by recognising the payment by the lessee to the lessor simply as a periodic rental expense. There was no recognition of an asset or liability by lessees. Interestingly, lessors sometimes already accounted for leases as a receivable, but approaches to recognise "unearned income" income varied. Other lessors used the rental method and treated the leased asset as a depreciable fixed asset and lease payments as income (reflecting the lessee treatment).

It was particularly attractive to lessee entities to not bring to account the leased asset or the lease liability, especially as trust deeds tended to count the liability but not the asset when calculating ratios. Their lease expense could either be constant or could even be shifted between periods if the lessor was amenable.

Between 1970 and 1980 many countries saw the use of lease financing mushroom. For plant and equipment leases in Australia, the value leasing agreements at year end increased by nearly 1800% over that period. An improvement in accounting was generally perceived to be needed, prompting the standards I have mentioned.

General accounting has steadily moved away from a "bricks and mortar" view of what constitutes an asset and from a legal notion of a liability. It has moved to the economic notion that assets being rights and obligations (whether legal or not) being liabilities. In part this was necessitated by an increase in the structuring of many types of transactions in ways that saw some attributes of physical assets and legal liabilities being split apart and/or re-bundled to suit the transacting parties. Sometimes this structuring was aimed at achieving off-balance-sheet accounting, but also it was because of finer ways of distributing the benefits of transactions (including taxation benefits) between the parties. More generally, accounting has become more conceptual and adopted economic notions of assets and liabilities in many areas.

The first main approach to reforming lease accounting in the 1980s (through to now) involved moving some leases from a rental model to a quasi-purchase model. A distinction was drawn between operating leases (rental arrangements) and finance or capital leases (quasi, mortgage-like, purchases). The former continued to just generate rental expenses and the latter saw the lessee accounting for an asset and a lease liability, as well as the depreciation and interest expense arising from them. International and many domestic standards have been attempting, with only limited success, to have this dichotomy followed for the past 20 to 30 years.

As there are perceived benefits for a lessee from not having to bring leased assets and liabilities to account - lower apparent leverage, smoothed expenses, ease of accounting- there are incentives to make sure that leases are classified as operating leases. When combined with inadequate approaches to consolidating entities controlled by lessees, current lease accounting has been poor, exacerbating criticisms of off- balance sheet accounting. The percentage of finance leases to operating leases has probably varied across jurisdictions but, even at its best, capitalisation of finance leases has been much lower than economics would suggest.

Criticisms of financial reporting for leases during the global financial crisis, especially in the US, were brutal, adding to the pressures for revised standards and an end to an industry devoted to justifying structuring.

So what is the current proposition of the IASB?

Again, conceptually this is not difficult to convey. If, as a lessee, you have a right to use say plant or equipment and an obligation to pay for that right, you should, bring that right to use to account as an asset along with the liability to pay for it. There would be no distinction between operating and finance leases for lessees or for lessors. All material leases would be on balance sheet. The right to use could be for some or all of the rights embodied in the underlying leased item. The language relating to quasi purchases for lessees has, therefore, given way to "rights to use".

In short, conceptually the proposed approach would bring all leases onto balance sheet, rather than some as at present. I will come back to variations on this theme when I explain a little more of current debates about how to implement the IASB proposals, which include some scope concessions which would reduce the number of leases captured.

Are the Current Proposals/Deliberations of the IASB Pointing to the End of the Journey?

If the IASB does bring most leases onto balance sheet will they have brought lease accounting into line with modern financial reporting requirements?

No, I don't think so. My reasons for saying this come down to the mechanics of the current proposals and the excepting of lease accounting from certain other IFRS standards. But the direction would be towards the general principles.

There are two basic sources for future development of the leasing model, that is, beyond this set of proposals.

Firstly, the lease accounting proposals contemplate unique accounting for options, guarantees and contingent rental payments. They have not borrowed significantly from the financial instruments' standards in for derivatives that are common in leasing arrangements and the proposals continue to treat lessee contingent rental payments as if they are period expenses for lessees when they really should be estimated as part of the obligations to pay. The treatment of contingent rentals has the potential to render capitalisation of some leases meaningless as the contingent rentals can dwarf the minimum lease payments.

Secondly, if the IASB provides exceptions within the model, it is highly likely that the industry will try to arbitrage those exceptions. US accounting for leases has depended on specified criteria relating , for example, to the relationships between the present value of lease payments and the fair value of the leased asset and to the percentage of the useful life of the asset represented by the lease term. Games have been played around those criteria to ensure that they are rarely met. The IASC and IASB tried to focus on the substance of finance leases and have those principles supported by similar rules to those of the FASB. More leases have been capitalised under this focus on principle, but far from enough.

The IASB has been trying to deal with complaints that capitalising leases can lead to higher expenses than previously recognised when lease rentals were expensed as incurred. This is because the sum of the depreciation or amortisation expense for the right to use asset and the interest on the lease liability will usually exceed a lease rental expense early in a lease. This issue depends heavily on the profile of the leasing portfolio and in my mind has been given far too much attention.

The IASB has toyed with the idea of having a single expense equal to the lease rental, by capping the depreciation part of that single expense. The total expense would then, all things being equal, in the P&L be similar to, or equal to, the cash payment available from the Cash Flow Statement. Of course, this will not work out when the cash payments are shifted between payments. The possibility that the leased asset would be revalued also points to problems with this approach. An under-depreciated asset with a limited life may well run into impairment problems which will confound the smoothed expense being contemplated.

IASB staff papers have been canvassing this single expense approach either for leases of property or for all leases previously classified as operating leases. If the latter was followed, classification rules would still be needed to distinguish finance and operating leases – a distinction not well made to date. But all leases would be on balance sheet. The games will probably be played around the arbitrage presenting itself in the income statement.

I can see no logic in this single expense model and think it is a function of lobbying by those not wanting to see a changed pattern in expenses. I see nothing in the approach for users of financial reports, except confusion and bills for consultants working to achieve the best classification.

The IASB has also been considering another form of distinction between capitalised leases; that is between property leases and other leases. The single expense model would be used for property leases and all other leases would be treated like finance leases with separate expenses for amortisation/depreciation and interest.

There seems to be various underlying reasons driving the desire to treat property leases differently.

One is that leases that transfer very little of the service potential of an asset to the immediate lessee would, under the right of use model, see lessors with a small receivable and a large right of return for the unguaranteed residual portion of the leased asset. That would worry lessors who have financial liabilities from financing the leased asset and who will have limited accounting offset on the asset side of the balance sheet. The receivable would provide some cover, but the intangible asset for the right of return would need to be accounted for differently from financial, investment property or PPE assets under current standards. The IASB has considered accreting the right of return, but this seems to be quite a stretch under current principles.

A further reason ventured is that lessors could have a myriad of leases in large properties. This is essentially put as a practicality problem that might be characterised as a large dog (investment property) being wagged by many small tails (leases).

In essence both of these lines of argument in relation to lessors are about not wanting to account for the rights comprising a "leased asset" when they are relatively small in the immediate lease to the total rights that could be transferred over the life of the "leased asset". This is really a rejection of the right of use model in favour of accounting for the physical asset.

Looked at this way, you can see for lessees a similar situation when a physical asset is leased for a short rental period (e.g. a car hire). The right of use is disproportionately small compare to the obligation to return the asset. The pragmatic answer from the IASB is for lessees to not to account for the unguaranteed residual from the beginning of the lease by only accounting for what will be used and the payments therefore. These won't be grossed up for the "whole asset" transferred and the liability to return the part of that asset not usable by the lessee. The lessor does not have this option as the asset to be returned will be very significant to their balance sheet and will have been acquired "gross" before the lease is commenced.

A third reason for the journey being partial is that the IASB feels compelled to ease the burden of the lease accounting where the leases are short term (for less than 12 months). This is an odd proposal as one needs to start from the position that immaterial leases will not be covered by the standard anyway. So here we are talking about exempting material short term leases.

I would stick with immateriality which is not time bound and I am not convinced this exception is worthwhile practically. Leases of less than 12 months that are material are not that common. I also worry that people's understanding of materiality won't be helped by this novel approach.

Exceptions Obscure Principles

We continue to learn the same lesson in accounting over and over again. The provision of exceptions, the prescribing of methods not true to principles and the use of arbitrary classifications are the source of both complexity and poor accounting, no matter how well intentioned.

My personal view is that the right of use model is correct and that the problems it presents are largely due to inadequacies in other parts of our accounting requirements (especially in relation to intangibles). I would therefore follow a single accounting model for all leases, transferring the pressure to improving other standards.

Having said this, I do not believe the IASB will deal with all the issues raised above and so whatever it decides now will be another chapter in trying to get lease accounting to accord with the general principles of accounting. Hopefully, the big plus from the current debates is that we do accept the right of use model and that we do get most leases on balance sheet.

Am I optimistic about this? Yes and no. I think lessee accounting could be taken to the single model if the IASB gives up the desire to smooth lease expenses. It seems to me that resistance to reforming lessor accounting may not be overcome. Some see lease receivables and investment property accounting as enough for now. Others think that the IAS 17 model should not be changed.

Complicating matters is that the FASB has favoured the dual model for accounting for leases and seems unwilling to move from it. The IASB was originally almost unanimous in favouring the single lease model – but changed ground for convergence sake. It is not clear that this shift will result in the issuance of a converged standard.

The Current Clamour

When lease accounting as we know it was first introduced in the late seventies and early eighties the controversy was extreme. Claims were made that it would be the end to businesses, contribute to unemployment and harm whole economies. It didn't. We see those same sorts of claims being made now. They are also highly likely to be false.

How could capitalisation of all leases lead to business failure? Why wouldn't more comprehensive accounting for assets and liabilities reduce uncertainty for users and lead to better control and decision-making by management? When is off-balance-sheet financing ever appropriate?

I can see only three conceivable scenarios in which lease accounting could lead to failure. It could reveal that a business is too highly leveraged causing financiers to withhold or withdraw funding. The costs of implementation could be so horrific that they overwhelm a business or a lessor business could fail because it is falsely built on financial reporting optics rather than economics.

I think these lines of argument must all fail.

Firstly, no business should enter a lease or conclude on the lease versus purchase decision without understanding the cash flows involved and the relativity of the respective costs. In short, the information needed for lease accounting should be largely available. These days software is readily available for the recording of leases, software which will generate the debits and credits in the same way as do fixed assets registers. Yes, some businesses may have vast numbers of leases, but this is not an argument for slack accounting.

Secondly, if capitalisation of leases would impact creditors and lenders, I would argue that the lenders are either not controlling their activities properly or lessees have been misleading them, not to mention the shareholders or other equity participants. Any sensible financier will demand information about lease commitments. Those users depending on financial reports are not so well placed and need to better understand the impact of leasing on a reporting entity.

Concluding Comments

I hope this overview will help those who are impacted by what we do in financial reporting to broadly understand the debate which they are hearing.

Some 36 years into lease accounting experience, both in standard-setting and as a lease accounting person in practice, tells me that capitalisation of all material leases is very much needed, the accounting arbitrage industry in this space needs to be shut down and that exceptions from general principles only bring unnecessary complexity. I hope the IASB decides to proceed so that all material lease assets and liabilities are on balance sheet and that they avoid combining and smoothing resulting expenses.

Beyond this era, I hope that the IASB moves further towards a principled approach towards lease accounting, learning much from the standards on financial instruments and other areas. Leases are not unique in the way in which they give rise to assets, liabilities, revenues and expenses – we just treat them as if they are. This is both a disservice to the users of financial reports and is not conducive to good management of assets and liabilities.

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