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Long awaited transparency for lease obligations

The new lease accounting standard brings much needed transparency to lessee lease obligations, bringing all leases onto the balance sheet. Although it's taken more than three decades, investors will finally have reliable information about leasing obligations, with less need for "rules of thumb" and guesses about the impact of lease obligations on a lessee's debt gearing/leverage. Currently only some leases categorised as "finance leases" are reported on balance sheet, "operating leases" are disclosed only in commitment notes. Lessor accounting will remain largely unchanged.

Investors and analysts will also like that for lessees, the lease obligations and other loan obligations will have consistent accounting treatments. Indeed, the collapse of Borders in 2011 highlighted the importance of operating lease commitments to the going concern of an entity when Borders was unable to terminate some of its USD 2.8 billion operating lease commitments to protect its profitability. At the time, those commitments amounted to roughly 7 times Borders' reported debt. In this case, defaulting on operating lease commitments played a significant part in the downfall of Borders resulting in calls for those obligations to be brought onto an entity's balance sheet to be treated in the same manner as other debt.

Bringing operating leases onto the balance sheet will require a significant amount of effort for preparers, however, preparers will benefit from having greater control over the information that analysts will use. The application of the new standard could reduce the amount of additional information entities would ordinarily release about their lease commitments in response to analyst queries.

The standard issued by the International Accounting Standards Board (IASB) will be called IFRS 16 *Leases*, and will be considered by the Australian Accounting Standards Board (AASB) at its 23-24 February meeting, for adoption in Australia. This change is also imminent for US GAAP reporters as the Financial Accounting Standards Board (FASB) is expected to issue an Accounting Standard similar to IFRS 16. While the US GAAP requirements will have some differences to IFRS, the underlying requirement to record all lease obligations on the balance sheet is the same. The IASB expects that this change will impact an estimated USD 3.3 trillion leasing commitments of listed entities using IFRS or US GAAP, with 43% of those listed entities reporting in the Asia / Pacific region. Mining, aviation and retail industries are expected to represent the bulk of those leasing commitments being brought onto the balance sheet. Nevertheless, the change in accounting is not expected to have a fundamental business impact on these entities; the economics of entering into leasing arrangements are unchanged.

Australian investors and analysts have advised the AASB that the new IFRS 16 lessee model is a significant improvement. Kris Peach, Chair of the AASB commented:

> *The quest to bring all leases on balance sheet has been controversial. However, both the IASB and the AASB have conducted multiple rounds of consultations and extensive public Board considerations.*

Lease accounting has taken a significant step forward. When analysts are routinely making adjustments for operating leases it's a reliable indicator that accounting has not been fully reflecting the economics of leasing transactions. Capturing more detailed information about operating leases on the balance sheet may also lead to better decision making from management, as has occurred in other circumstances such as share based payments and defined benefit funds. Whilst the effective date of 1 January 2019 seems a long way off, preparers should not underestimate the systems changes that may be required to capture operating leases effectively.

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