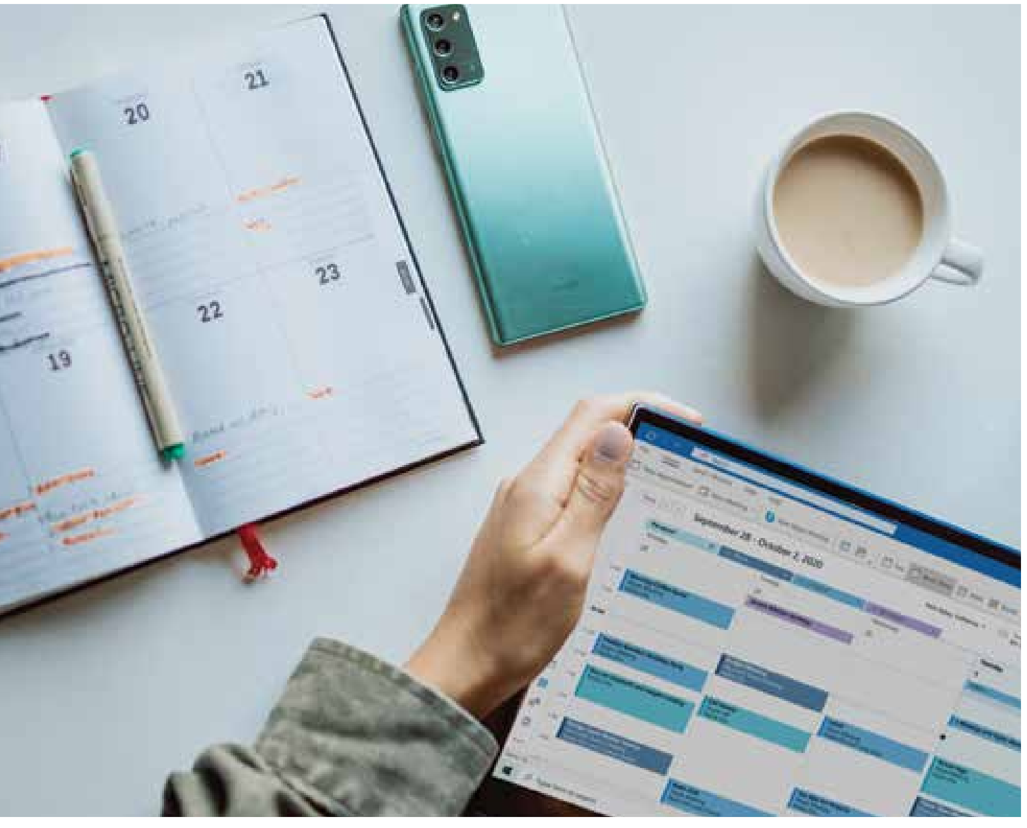
Leasing: Recent Changes to Rules Turn Balance Sheet Accounting on its Head

by Wayne Bartlett

It's been several decades now since I studied to be an accountant and one of the areas that I remember vividly scratching my brain about was the difference between finance and operating leases. All of that stuff about putting things on or keeping them off balance sheets struck home.

I understood the difference between the two and appreciated that if you leased an asset for the majority of its useful economic life, then it made intuitive sense that you should have that situation recognised on your balance sheet. On the other hand, if you only leased it for a small portion of its useful economic life it equally made sense that it was not recognised on your balance sheet. It seemed to me a very good demonstration of that important accounting concept of substance over form.

I never really thought that there might be an alternative way of looking at this. Users of financial statements became increasingly disillusioned with the high value of leases that fell into the operating category which did not appear on corporate balance sheets under the old rules. The number of disclosures required for all types of leases grew exponentially in an effort to compensate. Influential regulatory bodies such as the US Securities and Exchange Commission (SEC) began to express their concern at the non-reporting of so many leases on balance sheets. Due to pressure from them, it was eventually decided that the rules would be radically revised.



An example of Standard-setters speaking the same language

For many years, there have been efforts made to try and converge IFRS and US GAAP. A joint consultation process on potential changes was begun by both parties back in 2006. Revenue recognition and leasing were identified as two areas of joint interest. Views on lease accounting were sought from a wide range of stakeholders as part of this joint process. It took ten years to come to fruition but after over 1,700 formal replies from both sides of the Atlantic and beyond were received, an end-result was arrived at as far as both were concerned, with new Standards which are similar (though not identical) to each other.

In the US, this led to the promulgation of ASC (Accounting Standard Codification) 842 on leases which took the place of ASC 840. Within the IFRS framework, a new Standard was also issued, IFRS 16, which replaced IAS 17. Whilst there are still some detailed differences between US GAAP and IFRS, the guidance included in both is quite similar: a good example of what cooperation between the two Standard-setting bodies can achieve if the will is there, and the subject matter is of significant interest to both parties.

In recent months, several things have come to my attention which suggests that not all accountants are completely aware of the significance of the new standards, though I'm sure that does not go for everybody. This article is written with the aim of reminding everyone of the new rules so that they can be confident that they are applying them properly in practice.

The key elements of IFRS 16 and ASC 842

Both IFRS 16 and ASC 842 were released in 2016 though they did not come into immediate effect, IFRS 16 for example being mandatory from 2019 onwards. In the views of some commentators on IFRSs, it was the biggest change to the Standards in over a decade. Both IFRS 16 and ASC 842 require that all leases, regardless of whether they are finance (sometimes known as capital) leases or operating in nature, will be recognised on the balance sheets of the lessee (the body using the asset under the terms of the lease, as opposed to the lessor, its legal owner). There will therefore to this extent be no differentiation between finance and operating leases when comparing both frameworks. In IFRS 16, only very short-term leases (or 'small ticket' leases as they are sometimes known) are exempt from this requirement along with low-value items such as personal computers. All other types of leases will be treated in the same way as finance leases were treated in the past and put 'on balance sheet'. ASC 842 is very similar, with the exception that there is no exemption for low value leases.

The treatment of such assets on the books of the lessor is largely unchanged. There are a few detailed differences between IFRS and US GAAP; for example, on how a decision should be made as to whether a leased asset has been sold. Under the IFRS approach, the decisive factor is the transfer of the risks and rewards of ownership. With US GAAP, the key decision is based on control factors; similar to the philosophy underlying the recent changes to US standards on revenue recognition.

The impact of these changes

It was estimated when IFRS 16 was released that globally around $2.7 trillion trillion of leases were then held off balance sheets, a truly staggering number. Initial estimates were that over 50% of the world's listed companies will be affected by the changes. Airline, retail and travel/leisure sectors along with mining and construction companies were forecast to be particularly affected by the changes. Research suggested however that the impact would be varied in terms of geography, with those in Latin America seeing the greatest impact followed by those in the Asia-Pacific region. Businesses in Europe and North America were believed to have been the least affected, possibly because existing standards were already robustly enforced there.

The obvious impact of the new Standards in terms of absolute numbers is easy enough perhaps to understand – balance sheet values for what are now called 'Right of Use' assets will rise in the aggregate substantially. But financial metrics are also impacted. Earnings per Share (EPS) or other performance measurements may be impacted which could even in some cases impact on items such as bonuses that are linked to earnings. EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) will be impacted. With the change in treatment under the new Standards, operating lease payments are no longer charged direct to the income statement as they were in the past. Instead, they will be capitalised and depreciated, and payments will be split between capital and interest elements. The latter items are excluded from EBITDA.

Neither is it just the earnings on the income statement that are affected. So too is the balance sheet. Assets will go up in terms of value in most cases but so too will liabilities. This may affect gearings. For those with a large number of leases this could make their balance sheet look very different than it would have done under the old rules.

Some practical implications

There is a need to ensure that there is a comprehensive set of data available to implement the new rules now that so many leases are likely to be 'on balance sheet'. In the past, the only accounting impact of operating leases was the annual or periodic charges that needed to be fed into the income statement. Now many of these need to be given an asset value on the balance sheet. Better record-keeping is required. All lease documentation needs to be carefully logged and scrutinised. Internal communication needs to be good. Those setting up leases will not necessarily be accountants and the latter need to be fed information when new ones are created so that they are properly accounted for.

The degree of complexity is potentially significant for larger companies who operate over many sites and potentially even in many countries. There needs to be consistent, comprehensive and appropriate policies and procedures in place to ensure that the financial statements are produced in the appropriate fashion and are materially correct in terms of their content and presentation.

A degree of judgement is required too. For example, what in IFRS terms is a 'low value asset'? Some stakeholders might prefer that there was a definitive threshold number within IFRS 16 which could be applied in a black and white fashion but there is not, though the accompanying Basis for Conclusions suggests that a threshold figure of $5,000 may be an appropriate guideline in many cases. As always though users will need to work out what is appropriate for their own particular business and apply it accordingly.

The low-value threshold applies to individual items. Although on a case-by-case basis they may be immaterial, when aggregated they could potentially have a much more significant impact. However, they will still not be treated as 'on balance sheet'. This may appear to be a welcome reduction of the potentially complex nature of application in practice but what about if businesses have contracts for large numbers of items? In such cases there may be a need to go through line items in the contract one by one and assess whether they should be treated as low value items individually or not.

Many lease contracts can have a service element in them alongside a leasing of assets. If this is the case, then the two elements should be split out. The service element is to be treated as an ongoing operational expense and the lease of the asset separately dealt with in accordance with IFRS 16 or ASC 842 as relevant. Hopefully lease contracts will clearly define both elements separately; but this may not always be the case and documentation needs to be reviewed so that businesses can be confident that they have all the necessary information to hand.

Conclusion – what to watch out for

It is hopefully now clear that the new rules have a big impact on the way that leases are reported, for lessees particularly. The following measures need to be taken:

- A comprehensive database for all leases should be created if it does not already exist.
- Contracts should clearly differentiate service and leasing elements: if not, appropriate clarification from lessors should be sought.
- Accounting policies for leases should be reviewed and complemented by comprehensive data collection systems to ensure that the new rules are rigorously applied.
- Staff should be assessed to ensure they are fully briefed on how to account for leases and training provided to close any knowledge gaps.

Of course, not all businesses have leases and so not everyone is affected by the new rules. But those businesses that may have significant values involved in them, getting their reporting right will be fundamentally important for them in particular.

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