

Overhaul of Lease Accounting

Highlights

Eliminates “off-balance sheet” accounting for operating leases.

Distinction between finance and operating leases removed.

Balance sheets will grow and leverage ratios increase.

Lease costs are likely to be front loaded into earlier years of the lease.

Performance and cash flow measures such as EBIT, EBITDA and operating cash flow will change.

Lease-buy decisions will need to be re-analysed.

A new “right of use” asset will be recognized based on the present value of payments to be made over the term of the lease

Optional renewal periods that are ‘more likely than not’ to be exercised and contingent rental amounts must be factored in. These will be trued up through the Income Statement as facts and circumstances change.

Grandfathering of existing leases is not expected to be permitted.

Accounting by lessors and accounting under finance leases are also impacted.



Overhaul of Lease Accounting to bring fundamental changes to reported Performance and Leverage.

Sir David Tweedie, Chairman of the International Accounting Standards Board once remarked that one of his lifelong ambitions was to fly on an airplane that appeared on an airline’s Balance Sheet. Recently announced proposals under both IFRS and US GAAP to significantly change the accounting for leases bring this ambition closer to reality. They require that assets and liabilities arising from all lease contracts are recognised in the Balance Sheet with consequent impacts on reported debt levels, leverage and performance ratios.

What do the changes mean

Leasing is an important and widely used financing tool. It enables companies from start-ups to multinationals to acquire the right to use property, plant, and equipment without making large initial cash outlays.

Companies currently account for leases as either operating leases or finance leases. Lease classification is based on complex rules and “bright-line” tests.

Though an operating lease may provide nearly the same risks and rewards as outright ownership, the leased asset is not currently recorded on the balance sheet. Rather, rent expense is recorded throughout the lease term.

Many companies use operating leases, in part, because the leased assets and related liabilities are not recognized on their balance sheets. Some investors believe this makes it difficult to compare the financial positions and operating results of companies that buy assets versus those that lease equivalent assets. For these reasons, among others, lease accounting rules have been criticized for not portraying the economics of everyday lease arrangements.

Accounting standard setters have been working to create a single, comparable, worldwide leasing standard. They have generally agreed that all leased assets should appear on balance sheet. The recently published exposure draft addresses many criticisms of current lessee accounting and appears to have solid support. Because almost all companies enter into lease arrangements, they will have a pervasive impact for IFRS and US GAAP preparers.

The proposals in brief

Scope

The proposal applies to all entities, but certain types of leases are excluded from its scope. It includes leases of property, plant and equipment but does not include leases of intangible assets, assets to explore for or use natural resources (such as minerals, oil, and natural gas), biological assets or investment property which is measured at fair value.

Lessees

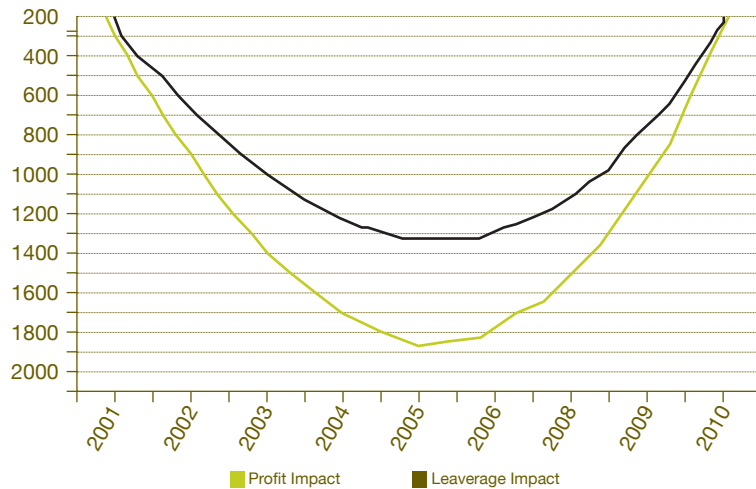
All assets currently leased under operating leases will be brought onto the balance sheet, removing the distinction between finance and operating leases. This new asset – representing the right to use the leased item for the lease term – and liability – representing the obligation to pay rentals – will be recognised and carried at amortised cost, based on the present value of payments to be made over the term of the lease.

The lease term will include optional renewal periods that are ‘more likely than not’ to be exercised. Lease payments used to measure the initial value of the asset and liability will include an estimate of ‘contingent’ amounts, such as rents based on a percentage of a retailer’s sales or rent increases linked to variables such as the Consumer Price Index (CPI).

The proposed model will require lease renewal and contingent rents to be continually reassessed, and the related estimates to be trued up as facts and circumstances change, thus introducing volatility to the annual lease expense.

Both positioning within the income statement and timing of recognition will also change. Straight-line rent expense will be replaced by depreciation, which will be recognised on a basis similar to similar owned assets, and interest expense, which will be recognised on a basis similar to a mortgage. This is likely to result in the lease expense being recognised earlier than heretofore.

Impact of profit and leverage



The Chart above depicts the impact on earnings and leverage for a basic 10 year lease with an initial annual rent of \$2,000, a 2% annual escalation rate and an assumed incremental borrowing rate of 7%

Lessors

Two alternative approaches are proposed for lessors.

- Where the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term of the contract or subsequent to the term of the contract, a ‘performance obligation’ approach would be followed. Under this approach, the lessor recognises the underlying asset and a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset.
- For all other leases, the ‘derecognition approach’ would be followed. The lessor recognises a receivable, representing the right to receive rental payments from the lessee and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognised and recorded as cost of sales.

Similar to lessee accounting, lessors under either approach would also need to estimate the lease term and contingent payments and true-up these estimates as facts and circumstances change.

Disclosures

The proposed model will require more extensive disclosures than are currently required under IFRS and US GAAP. The disclosures focus on qualitative and quantitative information, and on the significant judgements and assumptions made in measuring and recognising lease assets and obligations and may include some information which may be considered to be commercially sensitive.

Business and Commercial impacts

The proposals model will impact all aspects of the financial reporting system. The most pronounced impact is likely to be on financial ratios and, potentially, financing agreements and related covenants. Timely assessment of the impact on covenants, financing agreements and financing needs will provide opportunities to proactively start discussions with banks and other providers of finance. Companies will also need to assess the impact of the proposal on their financial ratios in comparison to their peers.

The proposal will result in the need for lessees to reconsider their lease versus buy decisions as the appeal of operating leases may diminish. Lessees will also need to consider renegotiation or restructuring of existing and future leases. These potential changes need to be aligned to a company's business needs without creating additional exposures or income volatility.

Business and legal structures supporting leases may need to be reassessed to evaluate whether these continue to be effective (e.g. Joint Ventures, Special Purpose Entities).

Financial performance and accounting impact

Both the Income Statement and the Balance Sheet are likely to become more volatile. Balance Sheets will expand by recording leased assets and related obligations. Leverage and capital ratios may suffer as a result.

Rent expense will be replaced in the income statement by depreciation and interest expense. Moreover, interest expense will be higher in a lease's early years compared to the current straight-line treatment for rent expense. Rent expense recast as interest expense will improve performance measures, such as EBIT and EBITDA, without changing underlying cash flows.

Internal controls and processes impact

Historically, many companies have not needed robust systems and controls for leases. The proposals will require companies to (re)design

controls and processes to ensure proper management and accounting of all lease agreements. The periodic reassessment of lease terms, contingent rentals and residual value guarantees at each reporting date may require significant and complex changes to existing processes and internal controls including support for, and documentation of, significant management assumptions.

IT and lease accounting systems impact

Current IT and lease accounting systems are based on the existing risks and rewards concept and may need to be modified to the proposed right of use concept. Lessees will have to account for and manage lease agreements (including existing operating lease agreements) and may need to implement contract management systems for all lease agreements and integrate these with existing accounting systems.

Lessees may look to lessors to provide them with information to support the accounting for assets and liabilities arising from lease agreements. Lessors may need to provide data to lessees that they do not have readily available and may therefore need to modify their IT and information systems and start automated reconciliation processes.

Tax Impact

The proposed lease accounting model will have a broad impact on the tax treatment of leasing transactions, since tax accounting for leasing is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will likely vary significantly, depending on the jurisdiction concerned.

Many jurisdictions directly follow IFRS accounting principles for tax accounting purposes. In these jurisdictions the tax treatment of leases will be directly impacted by the proposed changes. Although certain jurisdictions may not necessarily follow IFRS principles for tax accounting purposes, the

fact that the distinction between operating and finance leases will be eliminated, may impact the tax treatment. Companies that are active in such jurisdictions will be confronted with increased complexity as a result. Existing cross-border leasing tax structures are also likely to require reassessment, potentially opening up new opportunities.

Human Capital Impact

All agreements based on company specific key performance indicators will require a reassessment and, potentially, adjustments (e.g. remuneration agreements based on EBITDA etc).

On an ongoing basis, reassessing lease terms and payment estimates at each reporting date will require more effort than current accounting, which is set at inception and revisited only when the lease is modified or extended. As the proposals do not include grandfathering for existing leases, any transition project will need to gather data about lease term, renewal options, and payments to measure the amounts to be included on their balance sheets. Depending on the number of leases, the inception dates, and the records available, gathering and analyzing the information could take considerable time and effort.

The comment letter period ends on 15 December 2010; a final standard is expected mid-2011. Given the potential impact of the proposed changes on accounting and operations, entities should begin to assess the implications of the proposal on their existing contracts and current business practices. They should also consider commenting on the exposure draft to ensure their views on the proposed changes are considered.

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