

## IFRS industry insights

# Financial services implications of the revised leasing exposure draft

### The Bottom Line

- A revised exposure draft on lease accounting has been published by the IASB with a comment deadline of 13 September 2013.
- For lessors most properties being leased will stay on balance sheet in their entirety, but leases for other assets will often lead to a receivable and a residual asset being recognised.
- Leases that could extend beyond 12 months will come on-balance sheet for lessees, potentially impacting key performance indicators, gearing, lending covenants and regulatory capital.
- For lessees most property leases will have an overall straight-line expense profile, whereas for many other leases it will be front-loaded.

### What's happened?

The IASB has published a revised exposure draft (the 'ED') on lease accounting with comments requested by 13 September 2013. Whilst a number of problems identified by respondents to the exposure draft published in 2010 (such as the definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities undoubtedly remain. What is clear is that accounting for leases may prove time consuming and will inevitably require judgements to be made.

### Implications for the financial services industry

This publication highlights three issues from the latest proposals that will be of particular interest to those in the financial services industry. Of course many more complexities exist and, as described below, Deloitte has produced further guidance, exploring these in greater detail.

### Lessors keep most properties on balance sheet but only retain residual assets for many other leases

Lessors would keep most investment properties on balance sheet in their entirety, but derecognise many other leased assets and replace them with receivables and residual assets recoverable at the end of leases, which could impact the timing and recognition of profits. However, entities will need to perform a portfolio-wide assessment as to whether leases are able to continue to be accounted for under the operating lease model. Whilst this may be a straightforward exercise, it will nonetheless require lease-by-lease analysis and supporting documentation. For instance, for non-property leases, careful scrutiny will be required to determine whether, in effect, the lease term is for an insignificant portion of the asset's economic life.

Estimating the value of residual assets at lease commencement may prove onerous and require considerable judgement, with system upgrades potentially being required for their accounting.

The proposed requirements are complex and include estimating expected variable lease payments at the commencement of the lease in order to estimate the residual asset. Over the lease term the residual asset is accreted for the unwinding of the discount and adjusted for the expected pattern of variable rentals.

### Leases coming on balance sheet for lessees

Lessees would recognise an asset and corresponding liability on their balance sheets for their fixed future lease payments, similar to existing finance lease accounting. Aside from a few specific scope exclusions, the only other leases that could stay off-balance sheet would be those that have a maximum possible term of 12 months, including a presumption that extension options will be exercised. Concerns that such assets would be intangibles (potentially resulting in their deduction from regulatory capital) may, to an extent, be appeased by the latest proposals, which allow for separate presentation on the balance sheet or inclusion within the line item where the underlying asset would be presented.

### Assessing lease portfolios may require significant resource

### There may be increased pressure from lessees for shorter leases

## Lessees with straight-lined expense for properties but front-loaded for other assets

Unless a property is leased for the “major” part of its remaining economic life or the lease payments are “substantially all” of its fair value, the subsequent measurement of the asset and liability would yield a straight-line single lease expense. The same test would be applied for assets other than property, such as equipment, but a lower threshold of “insignificant” would need to be met and the asset’s total economic life considered. Otherwise, the expense profile would be front-loaded because the lease asset would be amortised on a straight-line basis, whilst the lease liability would be amortised using the effective interest rate method.

**Leases other than property would often include vehicles and equipment**

### Areas impacted by the proposals

Resource for transition	Assessing the classification of existing operating leases for assets other than property may require significant resource, particularly for leasing portfolios with large numbers of contracts. Where required, the estimation of residual assets’ values may also prove challenging.
Reporting systems	Systems would need to capture all information required by any new standard – the ED proposes extra disclosures beyond those currently required. Lessors’ systems may also require additional functionality to account for any residual assets. Closer relationships between finance teams and the operations teams entering into leases may be advisable to avoid undesired accounting consequences.
Banking covenants	Initial recognition of an asset and liability may not have an impact on a lessee’s net assets, but it could affect key balance sheet ratios, particularly if the liability is treated as a financing item. For leases with front-loaded expense profiles, any interest expense beyond that on existing finance leases could impact covenants based on interest cover. Renegotiations could be required. Renegotiations could be required.
Key performance indicators	Key metrics of a business’ performance could be impacted by the proposals. Depending on how they are calculated, measures such as return on capital may be affected or need redefining. For those operating lease expenses that would be replaced with a front-loaded interest and amortisation charge, adjusted measures of lessees’ earnings which strip out the effect of interest, such as EBIT, may increase and those that strip out amortisation and depreciation as well, such as EBITDA, could increase by a greater amount. It remains to be seen how regulators will treat leased assets for the purposes of assessing regulatory capital.
Remuneration schemes	Performance related pay schemes could be impacted due to changes in key performance indicators. Again, renegotiating or redefining such schemes may be advisable.
Earnouts	Where acquisitions have included contingent consideration that is dependent on the acquiree’s future performance the effects of any new lease accounting would need to be assessed carefully.
Tax	The potential impact of the proposed lease accounting changes on cash tax and deferred tax would need to be reviewed by reference to tax legislation in each relevant jurisdiction.

## Resources

More detailed information on the revised ED can be found in Deloitte’s IFRS in Focus publication available from [www.iasplus.com](http://www.iasplus.com). You can also register on IASPlus to receive newsletters that provide updates whenever the leasing project is discussed at IASB meetings. The revised exposure draft itself can be accessed on the on the IASB website at [www.iasb.org](http://www.iasb.org).

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