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Centre for Corporate Governance – Australia

CFO Brief

Gearing up for change: New lease accounting proposals

In August 2010, the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) issued an exposure draft (ED)[1] which creates a new accounting model for both lessees and lessors and eliminates the concept of operating leases. These proposals will result in all leases being capitalised and the resulting assets and liabilities being recognised 'on balance sheet'.

This document highlights the key changes and financial and commercial impacts for lessees and sets out actions that CFOs should take in order to prepare for the changes. We will explore the impacts on lessors in a later edition.

Overview of the proposals

A high-level summary of the proposals for lessees is as follows:

- Lessees recognise a right-of-use asset and a liability for the obligation to make lease payments for all leases
- The obligation to make lease payments is calculated by determining the present value of the lease payments discounted at the incremental borrowing rate or the rate charged by the lessor, if reasonably determinable, and is based on the longest possible lease term that is more likely than not to occur (including an assessment of renewal options)
- Lease payments include contingent rentals, such as turnover and CPI-linked rent, and residual value guarantees. These lease payments are estimated by determining the probability-weighted average cash flows for a reasonable number of possible outcomes
- Service elements, such as maintenance or outgoings, included in leases must be separated from the lease components, and expensed as incurred. In addition, the identification of other business service arrangements which may be more broadly classified as leases, as opposed to service contracts, will be important
- Lessees will need to perform an assessment at each reporting period to determine whether there are new facts and circumstances that would significantly change the estimate of contingent rentals, residual value guarantees and renewal periods
- Adjustments to the obligation to make lease payments as a result of reassessment are adjusted against the carrying amount of the right-of-use asset, unless the adjustment relates to current and prior periods, in which case the adjustment is recognised in profit or loss
- The right-of-use asset is amortised over the shorter of its useful life and the lease term and is subject to an impairment assessment
- Lease payments are allocated between interest expense and the reduction of the lease obligation using the effective interest method.

Who will be significantly impacted?

- Companies with operating leases of property, aircraft, manufacturing equipment, mining equipment, technology, distribution and logistics services
- Companies leasing significant numbers of office equipment or vehicles
- Companies with other business service arrangements, which may be classified as leases.

Which leases will be impacted?

- All current leases that extend beyond 2011
- Leases currently being negotiated.

[1] The Australian Accounting Standards Board (AASB) have subsequently issued these proposals as ED 202 *Leases*

Impacts on financial metrics

Statement of financial position
Right-of-use asset
Obligation to make lease payments

- Assets and liabilities will be 'grossed-up' which will impact key ratios such as gearing
- Change in ratios may impact loan covenants
- Volatility arises from reassessment of contingent rentals and lease term.

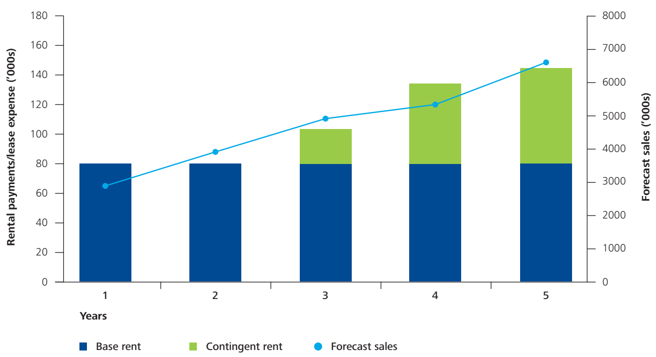
Statement of comprehensive income
EBITDA (now excludes operating lease expense)
Amortisation of right-of-use asset
Interest expense on obligation to make lease payments

- Operating lease expense replaced with amortisation and interest expense which results in an increase in EBITDA and EBIT
- Proposals create a different profit profile – net profit reduction in earlier years as interest expense is front-ended (like an amortising mortgage)
- Key ratios such as interest cover and return on funds employed will be impacted.

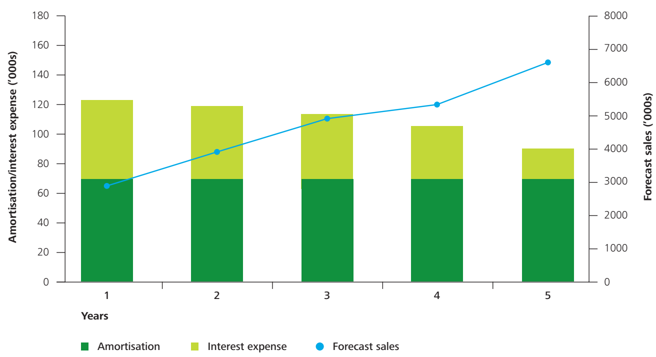
Expense profile

The following graphs illustrate the expense, before and after the proposals, that arises from a lease with contingent rentals (such as turnover rent) that is currently recognised as an operating lease. Under existing accounting standards, the expense that is recognised correlates with the cash payment and forecast sales, whereas the proposals generally result in a higher expense in the earlier years of the lease with an inverse relationship to forecast sales.

Existing lease accounting rules



Proposed lease accounting rules



The proposals generally result in a higher expense in the earlier years of the lease

Which stakeholders are impacted?

The proposals have the potential to impact many stakeholders. It is important that management engage with each stakeholder at the appropriate time to ensure that the impact of the proposals are fully understood and that the proposals are implemented in the most cost efficient manner.

Stakeholder	Considerations
Internal	
Finance	• Impact on financial report, key ratios and disclosures • Communication with investors and analysts.
Treasury	• Impact on ratios, covenants and debt renegotiation.
Information and systems	• Assessment of potential system needs – collation and capturing of data.
Business units leaders and strategy managers	• Determination of future strategy in respect of method of financing (e.g. buy vs. lease).
Internal audit	• Assessment of any system implementation, project risks, design of business processes and controls implemented to ensure process properly managed.
Acquisitions	• Impact on business valuation and free cash multiples, purchase price allocation and post acquisition ratios.
Human resources	• Impact on remuneration schemes • Hiring of additional resources to implement proposals.
Legal advisors	• Structuring of new lease and debt finance agreements.
Tax	• Tax on financial arrangements impacts • Deferred tax impacts.
External	
Investors	• Impact on financial report, key ratios and disclosures • Cost of implementation.
Analysts	• Impact on financial report, ratios and disclosures • Impact on business valuation and free cash multiples • Ability to access desired information.
Financiers	• Impact of covenants and debt renegotiations.

We expect that compliance will be time consuming and costly, and for some companies with a large number of complex leases even greater than that associated with the transition to A-IFRS

When are the proposals effective?

While the effective date of the final standard is as yet unknown, we anticipate that the proposals will not be effective before financial years beginning on or after 1 January 2013. This would mean that a company with a 30 June year-end would apply the proposals for the first time in the 31 December 2013 half-year report and the 30 June 2014 annual financial report. However, all leases outstanding at the beginning of the comparative period (1 July 2012) will be subject to the new proposals and there will be no grand fathering of existing leases, resulting in the restatement of comparative information.

Is there potential to influence the proposals?

While these proposals are in draft, we expect that the overall principle will not change as a result of any further deliberations by the Boards. Therefore, all leases will now be recognised 'on balance sheet'.

We believe, however, that there is still an opportunity through the comment process to change the mechanics of the proposals to be more practical and cost-effective for companies to implement. We would therefore encourage companies to respond to the proposals. The deadline to the AASB is 12 November 2010 and 15 December 2010 to the IASB.

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Conclusion

The proposals are wide-ranging and will impact many companies across many industries. We expect that compliance will be time consuming and costly, and for some companies with a large number of complex leases even greater than that associated with the transition to A-IFRS. It is therefore essential that companies develop and execute a well thought out plan to ensure a smooth transition. Through effective planning, potential problems and issues can be identified and addressed in a cost-effective way which results in 'no surprises'.

CFOs have an important role in ensuring the effective implementation of these proposals.

Appendix A sets out actions for CFOs to consider to address the major financial and commercial changes the new proposals are likely to have on companies.

Dates for the diary	
17 August 2010	Boards issue an exposure draft creating a new accounting model for leases.
12 November 2010	AASB comment deadline.
15 December 2010	IASB comment deadline.
December 2013/ June 2014	Earliest anticipated effective date (comparative period restatement of all leases outstanding on 1 January 2012/1 July 2012).

APPENDIX A – CFO Actions

Action	Response
Understanding the proposals	
Conduct an education session with the finance team and other stakeholders to understand the proposals.	☐
Conduct an education session to enable the board audit committee to understand the key proposals and high-level impacts on the company.	☐
Financial impact assessment	
Identify all arrangements which are in scope of the proposals, including contracts that will be considered leases but were previously recognised as service contracts.	☐
Perform an initial impact assessment on assets, liabilities, EBITDA, EBIT, net profit and key ratios.	☐
Determine a suitable process for managing the significant judgements and estimates that will be necessary with respect to estimating contingent rentals and the lease term.	☐
Consider the impact on existing loan covenants and borrowing arrangements.	☐
Consider the impact on borrowing arrangements currently being negotiated.	☐
Systems and resources	
Consider whether the information necessary to calculate the impact on the proposals is easily available.	☐
Does the company have a lease management system or central database?	☐
Is the data manually or electronically maintained?	☐
Does the company have sufficient resources in place to properly plan, manage and implement the changes, including ongoing reassessment of the change in estimates?	☐
Estimate the potential cost of implementation initially and on an ongoing basis.	☐
Other	
Determine when the impacts of these proposals should be included in budget information.	☐
Consider the impact on existing remuneration schemes, including bonuses and share-based payments.	☐
Consider the impact on the financing strategy of the company. Is it still appropriate to continue leasing, rather than buying the assets?	☐
Consider whether the change in calculation of EBITDA will impact valuation and free cash multiples.	☐
Determine what stakeholder communication is necessary for investors and analysts. Be prepared for any questions that analysts may have with respect to the impact of the proposals.	☐
Consider making a submission to the AASB and IASB setting out any concerns regarding the proposals and any recommendations to make the proposals more practical and easier to implement.	☐

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