Point of view
Consumer business implications of the revised leasing exposure draft

In a nutshell

- A revised exposure draft on lease accounting has been published by the IASB with a comment deadline of 13 September 2013.
- Leases that could extend beyond 12 months will come on-balance sheet, potentially impacting key performance indicators, gearing and loan covenants.
- Variable rentals will be expensed as incurred rather than being forecast and coming on-balance sheet.
- Most property leases will have an overall straight-line expense profile.

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definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities remain.

Implications for the consumer business industry

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

Leases coming on balance sheet

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 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. Despite property leases getting shorter in recent times the asset and liability for several years' worth of rental payments could be significant. For lessees, with breaks and options to extend on a property portfolio, it will be necessary to determine the expected exercise of these arrangements and ensure these judgements are consistent with their corporate strategy. Classifying leases may prove time consuming and will inevitably require judgements to be made. Lessees will need to perform a portfolio-wide assessment of existing classification. The initial and subsequent measurement of lease liabilities will present a significant data challenge.

The biggest leases for many will be retail outlets and office buildings

Variable lease payments

A significant change from the previous ED means that the liability and asset recognised by lessees would exclude variable rentals, unless they were based on an index or rate e.g. inflation-linked, in which case the spot rate as at commencement of the lease would be used. Any other variable rentals would simply be expensed as incurred. For example, if rentals payable on a retail outlet were determined solely as a percentage of sales then no asset or liability would come on-balance sheet and the rentals would be expensed in the same fashion as current operating leases.

Retailers often have sales-based rentals for their outlets

Lessees recognise a straight-line expense for most property leases but front-loaded for many 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 over the lease period. The same tests would be applied for assets other than property, such as vehicles and office 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	
Banking covenants	Initial recognition of an asset and liability may not have an impact on 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.
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.
Reporting systems	Systems would need to capture all information required by any new standard – the ED proposes extra disclosures beyond those currently required. Closer relationships between finance teams and the operations teams entering into leases may be advisable to avoid undesired accounting consequences.
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. You can also register on IAS Plus 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.

Contacts

Georgina Robb
grobb@deloitte.co.uk

Helen Burridge
hburridge@deloitte.co.uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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