Grant Thornton

Technical Accounting Alert

Proposed accounting standard regarding leases on the Statement of Financial Position

Introduction

The purpose of this alert is to provide details of a proposed accounting standard by the International Accounting Standards Board regarding the capitalization of all 'material' leases on the Statement of Financial Position. This will enable informed debate by those impacted by this radical change in accounting for operating leases, and provide feedback to Grant Thornton as it prepares its submission to the AASB and IASB.

Overview

The International Accounting Standards Board (IASB) has released for comment an exposure draft (ED) that proposes putting all leases on the Statement of Financial Position. The Australian Accounting Standards Board (AASB) will then release the ED for Australian constituents comment with an expected deadline of around early November 2010 (IASB deadline is 15 December 2010).

The IASB/AASB plans to issue a final accounting standard by June 2011 with an application date potentially for financial periods ending 30 June 2013 (comparatives for 2012).

The proposals have been subject to much global debate and whilst even the IASB acknowledges that the proposals will add costs to companies preparing financial statements, it justifies the proposals on the basis that there is widespread incompatibility in the accounting for leases with at times an artificial distinction between finance leases currently "on balance sheet", as against operating leases that are "off balance sheet" but rather disclosed as obligations for future payments. The standards setters view is that two quite similar leases can be accounted for quite differently given the current leasing standard requirements.

Additionally the IASB acknowledges that their proposals will lead to substantial increases in reported assets and liabilities for entities with operating leases, with consequent implications for asset and performance ratios.

The proposals can also be expected to have significant compliance implications for many entities which rely on leasing. Regulated entities may for example need to hold more capital to compensate for the increased assets recognized on their Statement of Financial Position.

More generally, the increased value of assets and liabilities recognized in the Statement of Financial Position may have an effect on the structuring of future transactions. The effect on loan agreements and bank covenants may need to be considered for example. Debt to equity ratios and other calculations of leverage may also be affected by separating operating lease expense into interest expense and capital repayment elements.

Whilst Grant Thornton Australia supports the decision to put all leases on a level playing field and hence capitalize as an asset the rights to the benefits of the lease with a corresponding liability to make on-going payments to the lessor, we are seeking the views of clients on the proposals given the increased complexity and costs for accounting for leases.

In particular Grant Thornton Australia is proposing to ask the IASB to:

- Exempt non-publicly accountable entities from the requirements of the new leasing standard although a better alternative would be to just allow adoption of the IFRS for SMEs accounting standard in Australia;
- Delay the application date of the final standard for a three year period so that there is an opportunity to review all existing operating leases; and
- Allow an exemption from capitalization for short term leases of less than 12 months where the leased item is not expected to be re-leased or replaced with a similar item. At the moment the only exemption is the general materiality requirement which applies at a 5-15% level for the appropriate class total of assets or liabilities.

A summary of the main proposals of the ED is as follows:

- Eliminating the requirement to classify a lease contract as an operating or finance lease;
- A single accounting model would instead apply for all leases with a lessee recognizing a 'right of use asset' representing its obligation to pay lease rentals;
- The individual components of a lease contract (such as options to renew, purchase options, contingent rental arrangements or residual value guarantees) would not be recognized separately. Instead, entities would recognize a single right-of-use asset and a single obligation to pay rentals that reflects expected outcomes; and
- A new hybrid accounting model for lessors, under which leases that expose the lessor to significant risks and benefits associated with the underlying asset will be accounted for using a performance obligation approach, while a derecognition approach will be used for all other leases.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact member or a member of the National Audit Support team via the GTAL IT Service Desk http://gtassist.au.gt.local/