

## Patricia McConnell: Will the elimination of operating lease accounting improve financial reporting by lessees?

24 June 2010



To address investors' concerns about off-balance sheet assets and liabilities that result from the application of today's lease accounting rules, we are proposing a major change to how lessees account for leases. We are proposing that all leases, regardless of their terms, be accounted for in a manner similar to how finance leases are treated today. However, our proposals go beyond merely eliminating operating lease accounting.

We propose to include in the amount 'capitalised' all expected cash payments under the lease. These amounts include contractual amounts due over the lease term as well the lessee's best estimate of contingent rents due over that period. The lease term is not just the term of the initial lease but includes renewal periods that are more likely than not to occur.

Today, under operating lease accounting, no asset or liability is recorded, while under finance lease accounting, only the contractual lease payments due over the initial lease term are included in the measurement of the recorded asset and liability. Consequently, the recorded assets and liabilities under our proposal may be greater than under lease accounting today, even for finance leases.

As a result of our proposals, assets will be higher resulting in lower asset turnover ratios and usually a lower return on capital. In addition, both current and noncurrent liabilities will be higher resulting in decreased working capital and an increase in the debt to equity ratio. Due to amortisation and interest expense related to the lease asset and obligation, if asset prices or lease payments are increasing or if a company is growing, profit or loss will be permanently lower than if operating lease accounting were used. However, operating income, operating cash flow, and EBITA will all be higher under our proposal than if operating lease accounting were used.

We would like your views on the following:

- Does the proposed accounting result in more useful information?

- Do you have concerns about considering renewal periods when calculating the lease asset and obligation?
- Do you have concerns about including contingent rents in the calculation of the lease asset and obligation?

### **Why a Project on Leases?**

For many years, we have been told that existing lease accounting doesn't meet investors' needs. The accounting depends on whether the lease qualifies as an operating or finance lease which is often a very blurry line. Therefore, investors adjust the financial statements to record estimated assets and liabilities arising from operating leases. Today, the underlying lease accounting principle is that, if the lease transfers substantially all of the risks and rewards of ownership to the lessee, it is treated as a finance lease. Finance lease accounting is very similar to the accounting for an asset purchased with borrowed money. The contractual lease payments are capitalised resulting in the leased asset and lease obligation being recorded in the balance sheet. So, a finance lease is sometimes known as a capital lease. The leased asset is depreciated and the lease payment is treated as if it was debt service. Part of it is treated as principal and reduces the lease obligation and part of it is treated as interest expense on the lease obligation. In the cash flow statement, the portion treated as principal reduction is shown as a financing cash outflow. Under IFRS, the interest expense portion is sometimes shown as an operating cash outflow but can also be shown as a financing or investing cash outflow. If a lease does not qualify for finance lease accounting it is treated as an operating lease. The leased asset and lease obligation do not appear in the balance sheet even though the lessee is using the asset and is contractually obligated to pay for its use. The lease payment is shown as rent expense in the income statement and treated as an operating cash outflow. Today, operating leases are a major source of 'off-balance' sheet financing.

Since operating leases allow a lessee to avoid recognition of the leased asset, its profitability ratios and indicators of operating efficiency are higher than if it used finance lease accounting or owned the asset. In addition, reported leverage is also lower because the obligation for contractual lease payments is not recognised as a liability. Because of these favourable financial statement impacts, leases have sometimes been tailored to achieve operating lease accounting.

Whether the lease has been structured to be an operating lease or whether the lease terms are legitimately meant to give the lessee

maximum financial flexibility, investors frequently adjust the financial statements to reflect the assets and liabilities arising in operating leases as if they were finance leases. However, this process is time consuming and cumbersome even with the extensive disclosure about operating leases provided in footnotes today.

### **Our Solution**

We believe the objective of lease accounting should be to ensure that all assets and liabilities used to produce shareholder value are included in the financial statements. Therefore, we are proposing a 'right-of-use' model. Under this model a lessee has acquired a right to use the underlying asset (a right-of-use asset) and is paying for that right with its rental payments (lease obligation). The right-of-use asset and lease obligation will be recorded in the balance sheet. Profit and loss will include amortisation of the right-of-use asset and interest on the lease obligation.

As under current finance lease accounting the initial measurement of the lease obligation will be the present value of lease payments discounted using the lessee's incremental borrowing rate. This will also be the deemed cost of the right-of-use asset. Subsequently, the right-of-use asset will be amortised. The lease obligation will be accounted for like a mortgage loan. The lease payments will be treated like debt service and split between principle repayment and interest on the obligation.

There is a major difference between our proposal and current finance lease accounting however. Under existing finance lease accounting, the lease payments included in the calculation of the lease asset and obligation are only the contractual payments due during the initial term of the lease. Under our proposal, the lessee will recognise the obligation to pay rentals for the longest possible lease term that is more likely than not to occur. In addition, the calculation of the lease obligation will include any contingent rentals expected to be paid during that term. The result may be a higher lease obligation and right-of-use asset at the inception of the lease even for leases treated as finance leases under existing standards.

### **Financial Statement Impacts of our Proposal**

The financial statement impacts of our proposals will be similar to those observed when operating leases are 'capitalised' for purposes of financial analysis. There will be an increase in assets which in turn will result in lower asset turnover ratios and perhaps lower return on capital. Both current and non-current liabilities will increase. This will

result in a decrease in working capital and an increase in the debt-to-equity ratio.

In profit and loss, rent expense will be replaced by amortisation and interest expense. For an individual lease, amortisation will be constant over the anticipated lease term and interest expense, like interest on an amortising mortgage, will decline over the anticipated lease term. So, initially profit and loss is lower, but in latter years is greater than if operating lease accounting were used. But beware! When asset prices (and lease payments) are rising, the impact of old leases nearing expiration may be more than offset by the impact of new leases. Also, if the company is growing and entering into leases at a faster rate than the old leases are expiring, reported profit and loss will remain lower than if operating lease accounting were used.

### **Operating Cash Flow and EBITDA will be Higher**

Under our proposal, lease payments will be treated like debt service, with a portion treated as interest, and a portion treated as a principle payment on the lease obligation. The interest portion will be expensed, while the principle portion will reduce the lease obligation in the balance sheet.

In the cash flow statement, we are proposing that the entire lease payment be treated as a financing cash outflow. That is a very different treatment from operating leases today and may differ from a company's treatment under finance leases today as well. Under existing standards, if the lease is an operating lease, the lease payment is all an operating cash outflow. So, under our proposal, reported operating cash flow will be higher than under operating lease accounting today. Today, if the lease is a finance lease, the interest portion of the lease payment maybe shown as an operating, investing or financing cash outflow, but the portion that reduces the lease obligation is a financing cash outflow. So, under our proposal, reported operating cash flow will be higher than under finance lease accounting today if the company's policy has been to show the interest expense as an operating cash outflow.

Note that EBITDA (earnings before interest, taxes, depreciation and amortisation) will also be higher under our proposal than if operating lease accounting were followed. Under operating lease accounting, rental expense reduces earnings. Under our proposal there is no rental expense, but rather interest and amortisation expense. These are added back to earnings to arrive at EBITDA.

### **Possible Concerns for Investors – Renewal Options and Contingent Rents**

We are proposing that the lease asset and obligation include lease payments over the longest possible lease term that is more likely than not to occur. Some commentators have expressed concern about the amount of management judgement involved in selecting the lease term. Another concern we have heard is that renewals are avoidable so that including them in the calculation of the obligation understates the amount of financial flexibility that the lease provides. We have heard similar concerns about our proposal to include managements' best estimate of the contingent rentals in the calculation of the lease asset and obligation.

We believe we have dealt with concerns about the application of judgement by requiring management to periodically reassess its judgements. In addition, required disclosure includes a breakdown of the amounts recorded between contractual minimum payments and contingent/optional payments. More importantly, we believe that including renewals and contingent rents provides investors with the best estimate of likely cash outflows. Also, we believe to exclude them will understate the assets being used to generate income as well as understate the amount of leverage being utilised. Further, not including renewal options and contingent rents will result in structuring opportunities. The lease could be structured with a very short initial term but with many, many renewal options and/or a very small contractual rents but large, virtually guaranteed contingent rents. We would like to hear your thoughts on these and any other aspects of our proposal.