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Accounting rules could lead to artificial lease structures

by Richard Crump 23 May 2013

BRINGING LEASES onto company balance sheets will be complicated, costly to implement and may lead to artificial structuring of lease agreements, critics of a proposed overhaul of lease accounting rules have warned.

International and US accounting rulemakers last week published a revised standard that will require companies to account for the assets and liabilities arising from all but the shortest leases on their balance sheets.

It was never the case that everyone involved with lease accounting would be satisfied by the IASB and FASB's joint proposal. Investors want more transparency about a company's lease liabilities; companies in turn want to avoid bringing vast sums onto their balance sheets.

The two standard setters have managed to remove a lot of complexity found in their original proposals, published in 2010, but are still facing dissent from the profession and within their own organisations. Indeed, three of the seven FASB members and two IASB members offered alternative views about the project.

Hidden gearing

In a press call following the standard's publication, Hans Hoogervorst, chairman of the IASB, accepted that it "is not very popular" and is a "conceptually a very difficult standard" but remained adamant that the hidden leverage leases represent outside of the balance sheet is not acceptable.

"At present, investors must take an educated guess to determine the hidden leverage from leasing by using basic disclosures in financial statements and applying arbitrary multiples. It is clearly not in the best interests of investors to expect analysts and others to guess the liabilities associated with leases," Hoogervorst said.

This view is not universally held however. According to Tim Bush, head of governance and financial analysis at investor lobbyist Pirc, lease charges do not represent hidden gearing (debt compared to asset ratio) but represent operational gearing (lease commitments compared to profits).

"The IASB's approach implies a company has the flexibility to sell an asset to discharge its debt commitment, which is not the case. The company will have a long-term contract to execute. It has a fixed cost," Bush says.

According to Darrel Scott, IASB board member, the off-book leverage contains an element of both. "Balance sheet gearing is real. You have a long-term contract that is there. There is an operational element to it that you need to be aware of," he says.

Dual approach

Criticisms of the rules centre around the level of enhanced disclosure requirements, the workload associated with transition to the model and the boards' dual approach to assessing leases, which the ICAEW described as a "compromise too far" for many.

The new standard will apply a dual approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease. The dual approach, based on how much of the asset is consumed during the lease period, is intended to better reflect the different economics of a wide variety of lease assets under a right of use model, whereby a lessor transfers the right to use an identified asset to the lessee in return for payments.

This approach will preserve straight-line expense recognition for most real estate leases in the income statement. For most other leases, such as equipment or vehicles, there would be interest and amortisation expense recognition asset separately from interest on the lease liability.

However under long-term leases - classified as Type B leases - the lessee would realise in its income statement a single expense combining both interest on the lease liability and the amortisation of the right of use asset on a straight line basis.

This, according to Eddy James, technical manager at the ICAEW, is a "fudge" by trying to force through the depreciation of a right of use asset on a straight line basis.

"The straight line charge is made up of interest on the lease liability (which is higher in the early years of the lease) and the amortisation of the right of use asset (which is a balancing figure to force the overall expense to be straight line and which is therefore lower in the early years of the lease)," he explains.

Artificial structures

Rating agency Fitch has also warned that the proposals, which include an exemption that allows leases of 12 months or less and arrangements assessed as service contracts to remain off the balance sheet, could encourage companies to shift to short-term leases or restructure their agreements as service contracts.

Admittedly the boards have attempted to limit artificial structuring of long-term leases into short-term ones by specifying that the 12 months or less term must include options to extend. Nevertheless, companies may push for more short-term leases to avoid putting them into the accounts.

"Buy-side analysts are in favour, but as an auditor I have a number of problems," says Andy Simmonds partner at Deloitte and chairman of the ICAEW financial Reporting Faculty. "There are going to be more dividing lines, which gives scope to play games. There is an issue over whether a lease is a lease or not and you could see lease periods being made artificially short."

Bringing leases on balance sheet has been a long-cherished goal of standard setters. Back in 2002, Sir David Tweedie, the then chairman of the IASB, complained he had never flown in a plane that appeared on airline's balance sheet. "We all have leasing standards...they are all absolutely useless. None of them work," he remarked in a speech at the time.

In so much as the accounting boards wanted to improve transparency and comparability, the project should be deemed a success. But kinks in the rules remain, particularly whether there is a conceptual rationale underpinning the detail.

The consultation runs until 13 September. Given how far the two boards have come - not least in coming to a converged standard - there is still time for those kinks to be ironed out.