

Lease accounting has historically focused on identifying when a lease is economically similar to purchasing the asset being leased. When a lease is determined to be economically similar to purchasing the leased asset, the lease is classified as a finance lease and is reported on the lessee's balance sheet. All other leases are classified as operating leases and are not reported on the lessee's balance sheet. In the latter case, those leases are treated like service contracts, with the lessee reporting a rental expense (typically on a straight-line basis) in each period of the lease.

Many, particularly those in the investor community, have long viewed leases as financing transactions. However, a significant number of leases entered into worldwide are classified as operating leases. Because only a relatively small proportion of leases are actually reported on a lessee's balance sheet, many investors and analysts go to the effort of making adjustments to the reported amounts to put the obligation for future operating lease payments on a lessee's balance sheet. Unfortunately, the information available in the notes to financial statements is often insufficient to make reliable estimates of such off balance sheet liabilities or to understand the value of the assets being used in the lessee's operations. Investors and analysts are forced to spend time estimating the value of those liabilities (often using makeshift estimation techniques) when that time could be better spent analysing the performance and risks of the company.

In an effort to ensure that investors and others have sufficient information about a company's leasing activities, the IASB (together with the US national standard-setter, the Financial Accounting Standards Board (FASB)) is working on a project that would provide information about:

- the amount of a lessee's obligation to make lease payments; and
- the assets that a lessee has control over.

In effect, the project would result in operating leases being reported on the balance sheet.

Lessee accounting today

A lessee classifies a lease as either a finance lease or an operating lease:

- Finance leases are those that are economically similar to purchasing the asset being leased—generally, the amount that the lessee pays over the lease term is substantially all of the fair value of the leased asset. A lessee:
 - in the balance sheet, reports an asset (within property, plant and equipment) and a liability (within financial liabilities), measured on a discounted basis;

- in the income statement, reports amortisation/depreciation of the asset separately from interest on the lease liability over the lease term; and
- in the cash flow statement, separates the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).
- All other leases are operating leases. A lessee:
 - does not capitalise operating leases (those leases are accounted for off balance sheet);
 - in the income statement, reports a rental expense typically on a straight-line basis over the lease term; and
 - in the cash flow statement, presents cash paid within operating activities.

Those differences in the accounting for finance and operating leases have encouraged at least some companies to structure leases to obtain off balance sheet accounting.

What's changing?

The proposals would significantly change the accounting for operating leases of more than 12 months. For all practical purposes, the accounting for finance leases would remain unchanged.

A lessee would recognise assets and liabilities for *all* leases (of more than 12 months) on a discounted basis. The recognition and presentation of lease-related expenses in the income statement, and cash paid for leases in the cash flow statement, would largely depend on the nature of the asset that is the subject of the lease. The main effects are as follows:

- For the substantial majority of leases of equipment or vehicles, the balance sheet, income statement and cash flow statement would change.
- For the substantial majority of leases of property (real estate), only the balance sheet would change.

The benefits

- Greater transparency about the true leverage of a company, resulting in better information for users of financial statements. The proposals would improve the accuracy and comparability of the reporting of the effects of leverage and, thus, reduce costs for analysts and investors by reflecting the effect of *all* leases of more than 12 months on a lessee's balance sheet, and enhancing disclosures.
- Less need for judgement by investors and analysts, resulting in reduced uncertainty.

Effect on the balance sheet

A lessee would report an asset (a right-of-use asset) and a lease liability for all leases of more than 12 months at the discounted amount of lease payments to be made during the lease term. The asset would be presented within property, plant and equipment, and the lease liability would be presented as a financial liability.

A lessee would generally not include in the measurement of the assets and liabilities rentals that are contingent on future sales or usage and rentals payable in optional extension periods (similarly to finance lease accounting in existing accounting standards).

Effect on the income statement and cash flow statement

The presentation of lease-related expenses in the income statement, and cash paid for leases within the cash flow statement, would depend on the nature of the asset being leased and the extent to which the lessee consumes (or uses up) that asset.

- If the lessee is expected to consume more than an insignificant portion of the leased asset, the lessee would account for the lease similarly to a finance lease in existing accounting standards. This means that for the substantial majority of leases of equipment or vehicles (eg aircraft, ships, mining equipment, cars, trucks), a lessee:
 - in the income statement, would report amortisation/depreciation of the asset separately from interest on the lease liability over the lease term; and
 - in the cash flow statement, would separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).
- If the lessee is paying only for use of the leased asset (and is not expected to consume more than an insignificant portion of that asset), the lessee would account for the lease in the income statement and cash flow statement similarly to an operating lease in existing accounting standards. This means that for the substantial majority of leases of property (ie land and/or a building), although it would report assets and liabilities on a discounted basis on the balance sheet, a lessee:
 - in the income statement, would report a lease expense on a straight-line basis over the lease term; and
 - in the cash flow statement, would report the cash paid within operating activities.

Service contracts are outside the scope of the proposals.

Enhanced note disclosures

The IASB is also proposing to enhance the information about leases available in note disclosures. For example, a lessee would be required to provide:

- a description of its leasing activities, including information about contingent rentals and term options;
- a maturity analysis showing the undiscounted lease commitments for each of the first 5 years, and a total thereafter; and
- a reconciliation of opening and closing balances for assets and liabilities recognised by the lessee, which results in information about balance sheet amounts and lease-related expenses being available in the notes to financial statements.

Comparison with US GAAP

Entities around the world enter into leases. Because of this, it is important that financial statements are comparable and, thus, this is a joint project with the FASB. The proposals are identical under IFRSs and US GAAP except for a few differences in disclosure, and to the extent that other requirements in IFRSs and US GAAP differ (eg asset impairment requirements).

Next steps

The IASB expects to publish a revised Leases Exposure Draft in the first quarter of 2013, with a 120-day comment period. In addition to the changes to lessee accounting discussed above, the Exposure Draft will also propose changes to lessor accounting.

We are seeking your views on the proposals. When the Exposure Draft is published you may provide your views by submitting a comment letter through our website or by contacting the project staff.

For more information

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