

Lease accounting: boards agree to allow time to adapt to new rules

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Podcast and article

Among a series of further decisions on the new accounting rules on March 2nd, the standard setters have agreed that an adequate lead-in period must be allowed.

The timetable

The final effective date is still to be agreed, but it now looks as though it could be January 1, 2015. It may depend in part on decisions still to be made on the transition rules – i.e. the extent to which revised lease accounting has to be adopted on a retrospective basis to leases already running at the critical dates.

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Podcast on March 02, Accounting Standards Board Meeting.

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In parallel with the consultation exercise on the leasing exposure draft (ED), the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued a separate discussion paper (DP) over recent months on effective dates and transition periods for this and other standards.

That consultation period ended on January 31. Both the leasing ED and the DP on effective dates brought a lot of comment from affected companies on the need for adequate lead-in periods.

The Boards' staff recommended that three new "convergence" projects in International Financial Reporting Standards ([IFRS](#)) and US generally accepted accounting practice ([GAAP](#)) – dealing with leasing, insurance and revenue recognition – should all be made effective on the same date. This is because of interdependent issues raised by the three draft standards, all at a similar stage of gestation.

The staff suggested that the common effective date for these new rules should be no sooner than January 2015. This was generally well received by the members of both Boards, subject to the outstanding transition issues.

For lessees and lessors directly affected by the new rules, their "date of initial application" (DIA) will be in advance of the effective date. Reports drawn up under the new rules will only be required to be issued after the effective date. However, there will be earlier comparative periods for which accounts originally drawn up under current rules must then be restated under the new rules. The DIA is the start date of the first comparative period to be restated.

Under IFRS new standards are made subject to a one-year comparative period for which earlier accounts have to be restated. For US public companies, however, [SEC](#) regulations require a two-year restatement under changed new rules.

So if January 2015 is confirmed as the final effective date, earlier accounts may then have to be restated under the new rules back to the start of 2013 or 2014.

The new standard will be released as soon as all the outstanding issues have been resolved. When the ED was issued last year, the target date for finalisation was June 30, 2011. At one time it seemed certain that this timetable would slip substantially. However, at meetings over recent weeks the Boards have now agreed on some simplifications to the proposals, and relatively early finalisation now seems possible.

Transition issues

For the leasing standard, the outstanding transition question is the extent to which the new rules have to be applied to leases running at the time of the DIA. It could raise issues for both lessees and lessors, wherever the new rules are different from the current ones. For lessees, however, the major transition impact will be on contracts currently classified as operating leases, which will go on-balance-sheet for the first time.

The ED proposed a "limited retrospective approach". For lessees, that would mean recognizing newly capitalized leases as if they had commenced at the DIA, on the basis of the rental commitments for subsequent periods only.

Some respondents among lessees and lessors pressed for purely "prospective" application, so that the new rules would affect only contracts starting after the DIA. Other respondents, including accountancy firms and some in the leasing industry, suggested that there should be an option of fully retrospective application. In that case accounts produced after the effective date (and covering periods from the DIA onwards) would be based on a restatement of all the accounting entries back to the inception of each lease running at the DIA.

There is no suggestion that all lessees would be in a position to adopt fully retrospective application, because of the heavy compliance cost and systems issues. However, assuming that purely prospective adoption is not allowed, the fully retrospective approach does have one advantage. It would avoid sharply fluctuating trends in profit and loss (P&L) recognition that could result from recognizing a large number of new leases notionally starting at the same date, under limited retrospection.

At the March 2nd meeting, the Boards agreed to seek further outreach consultations shortly on the transition issues, with groups representing investor and corporate analyst interests, and also with leasing software systems providers. Generally, there was not a high response rate from among these groups to the DP on effective dates, or the EDs on leasing and the other concurrent projects.

IASB representatives were supportive of the 2015 effective date, in the light of global regulatory implications. It was reported that some Latin American countries applying IFRS would need a long lead-in period, because of required amendments to local company law.

Earlier adoption, compared with the required DIAs, is likely to be permitted as an option. It was reported that in Japan, which is in the early stages of transition to IFRS, some companies might need to opt for early adoption, to avoid having to start applying the existing [IAS 17](#) leasing standard and then adapt again to the new one.

Some FASB members suggested that a 2015 effective date might not be soon enough, if prospective application were to be allowed. However, the IASB generally requires some degree of retrospective application for all its new standards.

It seems likely that the two Boards will eventually concur on a form of retrospective application, and that both will adopt the 2015 effective date. They are aiming to publish firm plans for the effective date and transition principles by around mid-April. The standard as a whole will not be finalised as soon as that, however, since several outstanding substantive lease accounting issues will take rather longer to resolve.

Public and private companies

In many jurisdictions subject to IFRS, including most EU countries, the new leasing standard initially will affect only public quoted company accounts. Private company accounting is subject to local GAAPs, where the leasing rules may eventually be brought into line with the new IFRS standard but with a later effective date.

US GAAP rules generally apply to all entities. In the recent DP process, FASB nevertheless raised the possibility of applying later effective dates for the new standards for private companies. No final decision has been made on this. Some US private companies asked for a later date for them, while public company respondents generally opposed the idea. The issue has some sensitivity for many lessees who act as US government contractors, due to the possibility of lease rentals having to be re-characterized as interest and amortization.

That could affect the ability of service suppliers to recover costs from government clients, where equipment leasing costs have been incurred by the contractors. Public company contractors expressed concern to FASB that they could be placed at a disadvantage against private company competitors during transition, if the latter were allowed a later effective date.

It is possible that this issue for US government contractors has become less acute since the Boards' decision last month on allowing the continuation of operating lease accounting for P&L purposes in the case of "other-than-finance" leases. However, that will depend on outstanding issues in how to define those leases.

The principle of capitalization

On March 2nd the Boards formally reviewed the principle of bringing operating leases on-balance-sheet for lessees, in the light of the ED response. Unsurprisingly perhaps, they reaffirmed the decision with no substantial debate.

Their staff report noted the concerns expressed by ED respondents on the cost/ benefit aspects. However, it suggested that the decisions made last month on lease renewals, contingent rentals and the identification of a lease (see previous AFI reports) should all help to ease the most problematic aspects.

The Boards also unanimously rejected the suggestions of some ED respondents for excluding assets which are "non-core" in relation to the lessee's business model, such as office equipment and vehicle leases for many lessees. The Boards' staff report on this stated: "... Defining non-core is difficult and many items noted as non-core could be resolved by applying the materiality threshold in IFRS and US GAAP."

This is perhaps an issue that leasing practitioners and advisers will need to consider further in the run-up to implementation. It has generally been considered that the threshold for disregarding immaterial items under accounting standards is a very low one, but it may depend on the relative value of a contract in terms of the scale of the lessee's business.

Leasing of intangibles

The Boards also confirmed that with some exceptions (see below) leases of intangible assets will be kept out of the new standard.

Under existing lease accounting rules, there is divergence between IFRS and US GAAP on intangibles leases. IAS 17 includes leases of some intangibles, such as software leases which are of some importance in asset finance.

FAS 13 presently excludes all intangible leases. However, a separate practice note in US GAAP (Subtopic 350-40) permits software lessees to "analogize" to lease accounting rules.

The Boards are considering the accounting rules for intangible assets in general under a separate convergence project, which is less well advanced than the leasing one. Because of the aim for early finalisation of the new leasing standard, it was decided to deal with leases of intangibles under the intangibles project, rather than the leasing one.

However, the Boards agreed some appropriate wording with a view to minimising disruption to existing accounting arrangements for software leases. Rather than excluding leases of intangibles from the scope, it will state that companies are "not required to apply" the standard to those transactions.

A separate standard IAS 8, addressing some general accounting policy issues, had been reviewed at a recent meeting of the IFRS Interpretations Committee. This considered the possibility of "analogizing" in situations where transactions are not addressed by a specific standard but other standards may point to a solution.

In the light of that review, the IASB feels that lessees and lessors presently accounting for software leases under IAS 17 will be able to apply the rules in the new leasing standard (pending the finalisation of the new intangibles standard), even though they will not be required to do so because of the scoping decision.

For US software lessees, the proposed "not required" rule in relation to intangibles in the new leasing standard will be subject to an exception referring to Subtopic 350-40, so that the transaction can be analogized to the new leasing standard.

Another exception to "not required" in the proposed rule for intangible assets at this stage is for sub-leases, where the sub-leased asset is the right of use (ROU) asset of the sub-lessor under the new leasing standard.

That exception presupposes that the ROU might itself be treated as an intangible asset. However, this does not pre-judge a separate decision on that question, which remains outstanding.

The ED was ambiguous (and in places contradictory) as to whether the ROU would be classed as a tangible or an intangible asset; and in most cases it might not make a significant difference to financial reporting.

However, the issue is critically important to banks as real estate lessees in their branch networks etc. For under the Basel regulatory capital rules, the impact of having to capitalize such leases could be much greater if the ROU asset is classed as intangible rather than tangible. That question may be resolved by the Boards later this month.