

The future of leasing

The IASB and the FASB ('the Boards') plan to require all leases to be reported on balance sheet. The impact on lessee financial reporting, asset financing, IT, systems and controls could be substantial.

What would the change mean for companies that lease assets?

- Although a final standard is not imminent, the Boards appear ready to require all leases, not just finance leases, to appear on the balance sheet.
- Entities leasing 'big-ticket' items, including real estate, manufacturing equipment, aircraft, trains, ships, computers and technology would be greatly impacted. Entities with numerous small leases, such as office equipment and auto fleets, would also be affected
- Balance sheets would grow, leverage ratios would increase, and capital ratios would decrease.
- There will be a change to both expense character (rent replaced with depreciation/amortisation and interest expense) and recognition pattern (significant acceleration of total expense recognition relative to recognition pattern under current rules). Performance measures such as EBIT and EBITDA would therefore change.
- Lease obligations would require ongoing re-measurement. Significant changes to internal controls and accounting/information systems are likely to be necessary.
- 'Lease-buy' decisions may be affected.

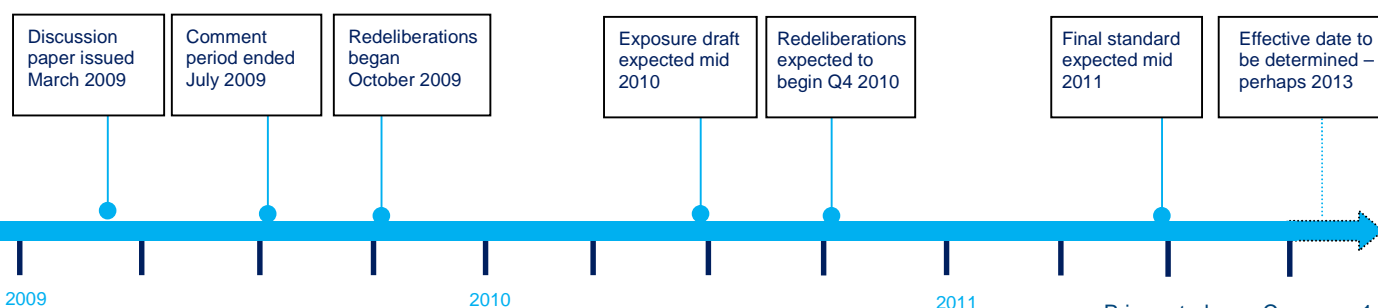
Background

Leasing is an important and widely used source of financing. It enables entities, from start-ups to multinationals, to acquire the right to use property, plant, and equipment without making large initial cash outlays.

Entities currently account for leases as either operating leases or finance leases. Lease classification is based on complex rules; where a lease is accounted for as an operating lease, neither the leased asset nor the obligation to pay for it are recorded on the balance sheet. Rather, rent expense is recorded on a straight-line basis throughout the lease term.

The IASB and FASB have been working to create a single, global leasing standard as part of their global convergence process, and building on previous work contained in the 1999/2000 discussion paper entitled '*G4+1 Special Report: Leases: Implementation of a New Approach*'. They issued a joint discussion paper in March 2009 and expect to release an exposure draft in mid-2010, followed by a final standard around a year later in mid-2011.

Timeline



The proposed model

The key elements of the proposed lease accounting model and its effect on financial statements are as follows:

- A 'right of use' concept will replace the 'risks and rewards concept'. Entities will recognise an asset and liability at the start of a lease.
- The distinction between operating leases and finance leases will be eliminated.
- All lease liabilities will be measured with reference to an estimate of the lease term, which may include optional extension periods.
- Contingent rentals and residual value guarantees will have to be estimated and included at the start of the lease.
- Lessees will be required to reassess the lease term, contingent rentals and residual value obligations at each reporting date.

The business impact

Businesses will need to undertake an in-depth review of the proposed changes in order to assess their impact on financial performance ratios (including debt covenants), taxation and compliance with the proposed standard.

The changes will require more information to be gathered and more judgements to be made on an annual basis. They will affect financial ratios and metrics, 'lease-buy' decisions, taxes, accounting processes and controls, and IT and lease accounting systems.

Lessees may need to consider re-negotiating or restructuring existing and future leases. Business and legal structures supporting leases should also be reassessed to evaluate whether these continue to be effective (for example, joint ventures and special purpose entities).

The developments may also significantly impact lessors' business models. They will need to emphasise the continuing benefits of leasing, consider the implications for lessees and whether existing products need to be revised.

Financial ratios and metrics

The proposed model will change both balance sheet and income statement presentation. Leverage and capital ratios may suffer from the gross-up of balance sheets. Rent expense will be replaced by depreciation and interest expense. In addition, the expense recognition pattern may change significantly. This will negatively impact some performance measures, such as interest cover, but improve others, such as EBIT or EBITDA, with no change in the underlying cash flows or business activity. In addition, continuous remeasurement will increase volatility of key ratios.

Timely assessment of the proposals' impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. Agreements based on (entity-specific) key performance indicators will require reassessment and potentially adjustment (for example, remuneration agreements).

IT and lease accounting systems

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept; they will need to be modified to the proposed right of use concept. Obviously, systems designed to meet the needs of this potential new pronouncement have not yet been created and must be developed. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. Lessees will need to identify and implement IT and accounting solutions that meet their future needs.

Lessees may expect lessors to provide them with the necessary information to comply with the proposed standard. However, lessors may not have, or may be unwilling to provide, data required by lessees. Consequently, lessees will need to capture such information themselves and may, therefore, need to modify their systems.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks.

Internal controls and processes

Many entities in the past have not needed robust processes and controls for leases. In addition to eliminating operating lease accounting, existing lessee accounting models (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The proposal that leases should be re-measured (for example, for changes in expected lease term) will require entities to (re)design processes and controls to ensure proper management and accounting of all lease agreements.

Initial recording on balance sheet and annual reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more resources than current accounting.

Timely assessment and management of the impact on processes, controls and resource requirements will help control your business and reduce reporting risks.

Information gathering

The proposed model does not currently include grandfathering for existing leases. Management will need to catalogue existing leases and gather data about lease term, renewal options and payments to measure the amounts to be included on balance sheet. Gathering and analysing the information could take considerable time and effort, depending on the number of leases, the inception dates and the records available. Beginning the process early would ensure that implementation of a future standard is orderly and well controlled and that data on new leases written before implementation of the changes is captured from the outset. In addition, it may allow entities to consider potential adoption strategies or to renegotiate agreements in order to reduce the impact of adoption.

Financial reporting

The financial statements will require restatement for the effect of the changes. The effects of the proposed lease accounting model should be clearly communicated to analysts and other stakeholders in advance.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognised on balance sheet; there is also likely to be a need for regular re-assessment of the lease term, contingent rentals, residual value guarantees or the impact of purchase options.

The impact of change will not be restricted to external reporting; internal reporting information, including financial budgets and forecasts, will also be affected.

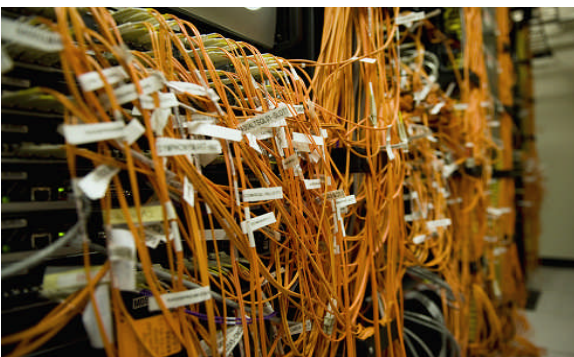
Tax impact

The proposed lease accounting model may have a broad impact on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalisation rules, percentage of EBITDA rules), existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Even where tax does not follow the proposed lease accounting model, management may see an increase in the challenges of managing and accounting for newly originated temporary differences in the financial statements.

Timely assessment and management of the potential tax impact will help optimise the tax position, by enabling entities to seek possible opportunities and/or reduce any tax exposures.



Questions and answers

Q: Is it possible that management will need to develop an entirely new system to track leases?

A: Many entities manage operating leases on spreadsheets or through their accounts payable system. The information needed to recognise and measure all leases on balance sheet at inception and then reassess expected lease terms and payments at each reporting date would require extensive data capture. Entities' information and systems needs will vary, but we expect most may need to modify their systems, processes and controls to comply with the proposed lessee accounting model.

Q: Why did the Boards tentatively determine that grandfathering of existing leases would not be allowed?

A: If all leases had a one- to two-year lease term, there would only be a short period of non-comparability. Some leases would be accounted for under the prior rules and some under the proposed rules. However, because many leases are for much longer terms, grandfathering existing leases would create, in the view of standard setters, an unacceptably long period of non-comparability.

Q: What if management cannot find the lease records of a lease entered into long ago?

A: The Boards recognise that management may not have some lease documents available when the standard becomes effective. Subsequent to the issuance of the

discussion paper, the Boards briefly discussed the method of transition. While details remain to be worked out, they recognise that practical transition guidance may be necessary.

Q: How would the proposal affect entities without many 'big-ticket' leases?

A: The proposed model will generally have a bigger impact on industries that lease high -value assets and real estate (such as in retail, professional and other services, transport and logistics, telecoms and healthcare), but it will apply to all leases regardless of asset value or lease term (some very short-term leases may ultimately be exempted). Moreover, businesses without many big-ticket leases may have large numbers of low-value leases, such as for cars and office equipment. The impact of the proposed model on large numbers of low-value leases could still be significant and is likely to give rise to a greater compliance burden. As a result, all entities are likely to need to evaluate the implications of the proposed model.

Q: Does the proposed model affect lessors?

A: Lessors may be affected if more entities decide to use alternative sources of finance. Lessors should therefore study the effects that lessee changes will have on their customers and overall businesses. In addition, the Boards are considering how lessor accounting should change to be consistent with the proposed lessee model

PricewaterhouseCoopers' benchmark study

PwC has performed a benchmark study to assess the impact of the leasing proposals on the financial statements and key financial ratios of a sample of approximately 3,000 listed companies across a range of industries and locations.

The study identifies the minimum impact of capitalising the operating lease commitments disclosed in the published financial statements. In view of the proposed inclusion of contingent rentals, residual value guarantees and lease extension options, the eventual impact may be much greater and may also impact the amounts recognised for finance leases. Furthermore, the study takes no account of any transitional reliefs that may be available on first-time adoption of any new standard.

Highlights from the study include:

- The average increase in entities' interest-bearing debt would be around 58%; the average increase in leverage (interest-bearing debt / equity) would be around 13%; and the average increase in EBITDA would be around 18%.
- The range of potential impacts is wide, but 24% would experience an increase in debt of over 25%.
- The impact also differs significantly from industry to industry. Industries that will experience the most significant impact on reported financial ratios are likely to be:
 - retail
 - professional and other services
 - transport and logistics
 - telecoms
 - healthcare
 - real estate
- Analysts, banks and rating agencies generally use a 'rule of thumb' to adjust the financial statements for the effects of operating leases. This 'rule of thumb' might differ significantly from the actual impact of adopting the revised standard.

How can PwC help

PwC has multi-disciplinary teams of specialists in many countries who can assist you in assessing the impact of the proposed lease accounting model on your business.

Depending on your requirements, we can:

- perform an individual assessment of the likely impact of the proposals on your financial statements and key financial ratios;
- benchmark the impact across peers and industry groups;
- assess the impact on data collection, processes, controls and IT systems;
- provide project planning support, training and investors relations advice;
- assist in the identification, selection, (re)design and implementation of new processes, controls and IT systems;
- assist in updating accounting manuals and providing staff training;
- advise on the impact on your existing tax strategies and methods for reducing exposure and optimising your tax position under the new model.

If you would like further information on the proposed lease accounting model or assistance in determining how it might affect your business, please speak to your regular PwC contact.

