



THE FUTURE OF LESSEE ACCOUNTING

Everything You Wish You Never Had to Know About the New Lease Accounting Standards

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OVERVIEW

Proposed changes to accounting standards represent a radical shake-up of accounting for leases. Under these new measures all lease obligations will be capitalised on the balance sheet. These proposals, if implemented, will have a profound impact on every company that is a user of real estate.

We are well positioned to advise our clients on the potential impacts and measures that companies will need to introduce to accommodate these proposals. The new lease accounting standards are likely to come into effect from 2013; however because of the need to restate prior year figures the true starting period could be from January 2012. This means that companies have another year to put changes in place. We urge our clients to start preparing for these changes as soon as possible.

EXECUTIVE SUMMARY

The proposed changes to accounting standards will add a substantive administrative burden on lessees, which will require an overhaul of accounting systems, controls and processes as well as a very significant data collection exercise. The initial implementation for businesses with a large portfolio of leased property will be particularly onerous.

Apart from implementation costs, the new standards will result in an asset and a liability being recognised in the financial statements. This immediate impact on the balance sheet will endure over the lifetime of the lease. If implemented as proposed the new accounting standards could significantly increase liabilities for some companies and have an adverse effect on key company performance metrics such as asset turnover ratios, return on capital and debt to equity ratios.

As the new proposals will negatively impact on a lessee's balance sheet and income statement, they

will make leasing look less attractive. We believe the proposed changes are likely to force property occupiers to look in greater depth at their property portfolios and in particular will increasingly require all users of property to assess whether they are better off owning or leasing property. For companies in a position to purchase a property that they are likely to occupy for a significant period of time, the new standards may well be the tipping point that makes ownership more attractive than leasing.

On the face of it would also appear that there may be a greater incentive for lessees to seek shorter leases. However, the new proposals will force lessees to adopt a probabilistic approach to lease length which takes into account "the longest possible lease term that is more likely than not to occur". This means that the tactic of electing for a shorter initial lease might not be effective if there is a significant probability that a lease will be renewed.

THE LEASE ACCOUNTING PROJECT

The International Accounting Standards Board (IASB) has published an Exposure Draft (henceforth ED) of its proposed new IFRS Leases as part of its global drive to harmonise accounting practices. If implemented, these proposals will have a significant impact on the financial statements of organisations that lease assets. Indeed the proposals are so radical they may impact business behaviour.

WHY ARE IASB UNDERTAKING THIS PROJECT?

Current lease accounting rules in IAS 17¹ are complex and difficult to implement. The result is that differentiating between Operating and Finance Leases, as is required by the standard, can be very challenging and somewhat open to manipulation.

Current Operating Lease accounting understates assets and liabilities. Consequently, indicators of gearing are understated resulting in users of financial statements making subjective adjustments based upon inadequate information that is provided in the notes to the financial statements.

The users of financial statements are showing increasing concern about the perceived use of off-balance sheet financing.

This project is being jointly run with FASB² and thus will equally impact those businesses accounting under USGAAP.

OVERALL PROJECT OBJECTIVES

The project's objectives are as follows:

- To develop a new accounting model for the recognition of assets and liabilities created by leases
- To ensure that lessors and lessees present relevant, faithfully representative information about the rights and obligations that arise from leases
- To ensure that users of financial statements are provided with useful, transparent and complete

information about leasing transactions in the financial statements

- To assist users of financial statements in their estimations of the amounts, timing and uncertainty of cash flows arising as a result of leases

SCOPE OF NEW PROPOSALS

The proposed standard will apply to almost all leases (both lessor and lessee accounting) with some exceptions³. Therefore the leasing of property is firmly within scope.

Where a lessor chooses to account for investment property at fair value under IAS 40 as is the case with the vast majority of property investors, IAS 40 should continue to be applied rather than the lessor/lessee accounting proposed by the ED, although the ED does propose some changes to IAS 40.

Consequently, this paper focuses on the changes to lessee accounting and possible consequences.

THE NEW LESSEE ACCOUNTING MODEL

Under the new proposals, all leases should be accounted for under a right-of-use model whereby the recognition of the right-of-use creates an asset on the balance sheet and the obligation to pay rent creates a liability that should also be placed on the balance sheet.

As a result, for all leases, except where an expense could be capitalised under another standard, the statement of comprehensive income will include:

- interest expense on the liability to make lease payments
- amortisation of the right-of-use asset
- any revaluation gain, if relevant, on the right-of-use asset
- any impairment losses on the right-of-use asset
- certain changes to the liability to make lease payments.

¹ IAS 17 Leases.

² FASB – Financial Accounting Standards Board.

³ The main exclusions are leases of biological and intangible assets, leases to explore and use natural resources and leases of some investment property.

These proposals differ substantially from the current standard as noted below:

Treatment of Leases under Current and Proposed Accounting Standards

OPERATING LEASES CURRENT STANDARD	ALL LEASES PROPOSED STANDARD
<ul style="list-style-type: none"> No asset or liability recorded on balance sheet Rent expense in P&L Disclosure of future minimum lease payments 	<ul style="list-style-type: none"> Lease results in a right-of-use asset and a liability to make lease payments that will be recorded on the balance sheet Amortisation and interest in P&L Additional information in notes

Source: Adapted from IASB Exposure Draft Snapshot: Leases, August 2010.

THE CONSEQUENCES OF THE PROPOSALS

The new standard will have a significant impact on lessee's financial statements.

Cashflow

In themselves the ED proposals do not affect cashflow and it is the IASB's view that accounting should not impact on business decisions and therefore should not impact on cashflow. We discuss this more in detail below but suffice to say that we believe behaviours may be affected by these proposals in which case there is potential for cashflow impacts.

It is also possible that cashflow could be impacted if the proposals result in a change in the way in which leasing transactions are taxed and clearly there is scope for the impact to vary between jurisdictions. For example, in the UK current taxation regulations would need to be revised since they currently deal with the taxation of operating and finance leases, both of which will technically cease to exist. It is also interesting to note that in the UK depreciation is not a tax allowable expense and therefore if the tax treatment going forward were to mirror the accounting treatment a significantly higher tax charge would result.

Balance Sheet

The ED proposals result in large assets and liabilities appearing on the balance sheet and in all probability a not insignificant reduction in equity throughout the lease term.

The consequences will be changes to financial ratios and associated performance measurements.

Typically:

- Asset turnover ratios will fall
- Return on capital will fall
- Debt to equity ratios will rise

In addition, consideration needs to be given to potential impacts on credit ratings and debt covenants.

Income Statement

The proposals result in an acceleration of the charge to the income statement. In the early years of a lease this could result in charges more than 20% higher than under existing operating lease accounting with a consequent drag on corporate earnings. On initial implementation all leases will effectively be accounted for as if they are in their first year and thus the short term impact could be very significant, particularly for those businesses with many long term leased assets.

PRACTICALITIES

It is currently anticipated that following the issue of the new lease accounting standard in 2011 implementation will be required for accounting periods starting on or after 1 January 2013. The need to restate prior year figures will mean that opening balances will be required for accounting periods starting on or after 1 January 2012; it would therefore make sense for businesses to, at the very least, put in place systems to prepare for the changes during the course of 2011.

AS CURRENTLY PLANNED ALL LEASES BOTH NEW AND EXISTING WILL BE SUBJECT TO THE NEW ACCOUNTING METHODOLOGY.

For existing leases it is currently proposed to account for the lease as if it had just been entered into, i.e. if at the accounting date a lease has 3 years to expiry it should (subject to renewal options, etc) be accounted for as a 3 year lease.

The initial work to account for the proposed changes will be very substantial and will entail businesses undertaking very significant data collection exercises, almost certainly the procurement of expert external advice on a number of matters, views to be taken on a number of subjective matters and potentially complex probabilistic modelling to be carried out on every leased asset.

FOR BUSINESSES WITH A SUBSTANTIAL NUMBER OF LEASED ASSETS, BOTH PROPERTY AND OTHER ASSETS, INITIAL IMPLEMENTATION WILL BE ONEROUS.

The key practical aspects are likely to be:

- Lease Administration – Comprehensive data on all leased assets will be needed, in particular this data will need to include the timing and nature of all future lease events, not just the next lease event
- Subjective Data – In order to generate the discounted cash flows required for each leased asset, forecasts of rental growth and/or inflation will be required as will estimates of incremental borrowing costs for each specific asset
- Probabilities – In order to generate the probabilistic scenarios that are required, probability assumptions will need to be made on matters such as break options and renewal options
- Cashflow Modelling – Cashflow models will most likely need to be built that interface with accounting systems and/or lease administration systems
- Collaboration – In order to achieve all of the above a high degree of collaboration is likely to be required, this is likely to include:
 - Real Estate
 - Financial Reporting

- Treasury
- Corporate Planning
- Transaction Management
- External specialist suppliers including real estate and systems suppliers

In addition to the initial implementation workload there will be an ongoing workload to review the lease accounting for each lease at each and every accounting date.

At each accounting date the core assumptions adopted in terms of rent and options, etc, will need to be reviewed to ensure that they do not differ significantly from those previously adopted. For example, it may be necessary to reassess the probabilities of break options being exercised based on updated business planning.

As with the initial implementation for businesses with a large portfolio of leased assets, the ongoing accounting will be onerous.

IMPACT ON THE MARKET

The Board's proposals are radical and will have a significant impact on the financial statements of organisations that lease assets. Indeed the proposals are so radical that they may impact business strategy and behaviour.

We have identified a number of areas where behaviour could be impacted.

To Own or to Lease

We believe the proposed changes to lease accounting are likely to force property occupiers to look in greater depth at their property portfolios and, in particular, will increasingly require all users of property to address the key question "Are we better off owning or leasing our property?"

ARE WE BETTER OFF OWNING OR LEASING OUR PROPERTY?

There is no simple answer to this question.

In order to arrive at an answer it is first necessary to establish the metrics against which "better off" will be judged. The metrics will judge a series of factors, both financial and non-financial. A significant complication in any analysis that is

to be carried out is that many of the factors are inter-related.

In addition to factors that are specific to the occupier of the property, a further series of property specific factors also need to be considered. On occasions it will be the case that an occupier that is most suited to leasing occupies properties that are best leased, however, it is rarely that simple. Rather it is frequently the case that a blend of ownership and leasing will be most appropriate and only through detailed analysis can the best blend be assessed.

It will be self evident from the above that it is only possible to truly answer the lease vs own decision if analysis is carried out at the individual property level.

A further complicating factor is that the answer may well vary from time to time not least because of economic / market related factors.

It is probably true to say that, to date, lease accounting has not been a major factor in own vs lease decision making.

In transactions such as sale & leaseback it is the case that the desire to achieve operating lease treatment has influenced transaction structuring and thus has impacted decision making but probably not the actual decision to undertake the transaction.

IF THE ED PROPOSALS ARE IMPLEMENTED WE BELIEVE USERS OF PROPERTY WILL PLACE FAR GREATER FOCUS ON THE OWN VS LEASE QUESTION

Under the proposals whilst it is probably the case that cash flow will not be impacted it is the case that the impacts on the balance sheet and income statement make leasing look less attractive. The entire ethos of the proposed changes are that leasing is a form of finance, if this premise is accepted and leases are to be accounted for on this basis it is very likely that businesses will wish to establish if leasing finance is the best form of finance.

We therefore believe that, where an opportunity exists to consider whether a property should be owned or leased that, a detailed property specific analysis should be carried out.

For cash rich businesses or businesses that have significant borrowing capacity and who have property that they are likely to occupy for a significant period of time, it may well be the case that there is a move away from leasing towards ownership.

In many other cases though, the perceived advantages of leasing or the inability to actually acquire a property that is leased/to be leased means that leasing will be more appropriate.

If capital is constrained, businesses will still need to decide if capital is best deployed in owning property or in core business activities.

LEASE TERMS

Where a decision has been taken to lease it is likely that lessees will seek to minimise the accounting impact through transaction structuring. The key lease factors that are open to structuring and will have a significant impact on the accounting are as follows:

Lease Term

The accounting impact is minimised by reducing the lease term thus, on the face of it, lessees may seek shorter lease terms.

Leaving aside the relative bargaining strength of lessors and lessees, that will ultimately determine the extent to which shorter term leases are available and the cost thereof, there are a number of issues that may impact on the suitability of short leases:

- Short leases do not give an occupier long term security, depending on the nature and location of the property this could expose the lessee to risk and/or a weakened bargaining position at lease expiry

- The lessee may seek to protect their long term occupation through the use of renewal options, however, the probabilistic approach to determining the lease length to be adopted for accounting means that such a tactic, if properly accounted for, will not be effective
- Short leases without renewal options will have a significant impact on the accounting treatment of matters such as the write-down of fit-out costs which are typically written-off over the life of the lease. It will not, for example, be possible to argue that fit-out costs are written-off over 10 years whilst only accounting for a 5 year lease

Rent and Rent Escalation

There may be scope to reduce the accounting impact by profiling rental payments in such a way as to reduce the discounted rental cashflow. For example, a low initial rent followed by higher increases throughout the lease will result in a lower accounting impact than would a higher starting rent followed by lower increases because of the impact of discounting.

Rent Escalation Methodology

It is interesting to note that under the proposed ED methodology it will be necessary for the lessee to predict the rent that is likely to be paid throughout the course of the lease; this is very different from what is required under IAS 17 where only guaranteed increases need to be considered.

Given that the ED proposals require a forecast of rent to be paid it is quite likely that lessees will seek to ensure, as far as possible, that the forecast increases actually take place and that variances from forecast are minimised. We therefore believe that it is possible that lessees will seek to agree lease terms that link to the forecasts being adopted. For example, if the best estimate of future rent payments is assessed to be the retail price index (RPI) it may make sense to actually agree that RPI linked increases will be paid rather than market increases.

Simpler still would be to agree fixed increases through the life of the lease which would therefore require no forecasting and cannot result in any accounting variances.

Changes to the basis of amortisation in accounts might lead to re-evaluation of the treatment of inducements at rent review and higher net effective rents.

Additionally, the requirement that occupiers will have to predict the probability of exercising break options, options to extend or to renew may force occupiers to be more explicit about their intentions. This might drive property strategies or weaken negotiating positions.

WHAT HAPPENS NEXT

In 2006 the IASB began the project to fundamentally review the way in which leases are accounted for under IFRS. The project is now well advanced with the Board's proposals formalised in an Exposure Draft (ED/2010/9) that was issued in August 2010.

Interested parties have until 15 December 2010 to respond to the ED. The board plan to issue the new standard in 2011, with the effective date expected to be for annual periods commencing on or after 1 January 2013.

AN EFFECTIVE DATE OF 2013 MEANS THAT FIRMS NEED TO START PREPARING FOR ITS IMPLEMENTATION NOW

In essence, this means that there will be a need to restate prior year figures so that the true accounting start period will be from January 2012, which means companies will have to start preparing during 2011.

APPENDIX 1: THE NEW LESSEE ACCOUNTING MODEL

BALANCE SHEET IMPACT

With the new standard resulting in an asset and a liability being recognised in the financial statements, there will be an immediate impact on the balance sheet.

Initial Recognition

The initial recognition of the obligation to pay rent is calculated as the present value of the lease payments, discounted using the lessee's incremental borrowing rate or the rate the lessor charges the lessee if it can be readily determined.

In the case of property leasing it is rarely the case that the rate the lessor is charging can be determined as the lessor's assumptions regarding matters such as rental growth and residual value will not be known. It will therefore normally be the case that for property lessee accounting the lessee's incremental borrowing rate will have to be used.

To determine the lease payments an entity will first have to determine the lease term. Where options to extend or terminate the lease exist, the lease term is the longest possible term that is more likely than not to occur.

Once the lease term is calculated, the entity will then need to estimate the lease payments over that term.

Having determined the initial measurement of the liability, the initial measurement of the right-of-use asset is simply the value of the liability plus any initial direct costs incurred by the lessee. The logic presumably being that the "value" of the asset is equivalent to the amount the lessee is prepared to pay to use the asset.

Subsequent Recognition

In subsequent accounting periods the obligation to pay rent is accounted for at amortised cost with the amortisation based on the effective interest method. In this way the liability decreases in the same way that a repayment mortgage would, i.e.

slowly at first and increasing in amount during the life of the lease. The ED also requires the lessee to assess if there have been any significant changes in the liability since last reported, for example, a significant change in the term of the lease.

In subsequent accounting periods the right-of-use asset is accounted for at either depreciated cost or fair value under IAS 16⁴. If depreciated cost is adopted the asset should be amortised on a systematic basis over the lease term as per IAS 38⁵.

The general presumption for property is towards adopting straight-line amortisation as the consumption of the asset's benefit should be equal through each accounting period of the lease.

If accounted for at fair value all leases in the class of property, plant and equipment must be accounted for at fair value. The ED makes it clear that fair value need not be determined by reference to an active market as there is no market as such for right-of-use assets, the draft does not however allude to how such a fair value could be measured. In the absence of any better methodology, it appears to be reasonable to adopt the same methodology as adopted for the initial asset value recognition, i.e. the present value of the remaining lease payments.

The ED makes a specific partial-exemption for short leases, i.e. leases capable of being no longer than 12 months in duration. Such leases are to be accounted for in a largely similar way to longer leases other than there is no need to discount the cashflow in order to calculate the right-of-use asset and liability obligation.

Presentation

The right-of-use asset will be presented within "Property, Plant and Equipment" as a separately shown right-of-use leased asset.

The liability obligation will be shown as a financial liability but as a separate item from other financial liabilities.

⁴ IAS 16 Property, Plant and Equipment.

⁵ IAS 38 Intangible Assets.

INCOME STATEMENT IMPACT

The proposed new model significantly changes the way in which rental payments are accounted for (when compared with current operating lease accounting).

The charge to the income statement will now comprise two components, amortisation and interest.

The amortisation derives from the amortisation of the right-of-use asset and the interest element from the effective interest method used to calculate the liability amortisation profile.

Unlike rent that is currently charged as an operating cost both interest and amortisation are charged below EBITDA with the result that EBITDA will increase although net profit will generally decrease in the early years of the lease and increase in the later years of the lease.

APPENDIX 2: WORKED EXAMPLES

WORKED EXAMPLE 1 – SIMPLE EXAMPLE

A lessee enters into a 5 year lease for an office property with a net internal area of 100,000 sq ft. The initial rent is £20 per sq ft, £2,000,000 per annum payable quarterly. The rent increases at a fixed rate of 2% per annum. The lessee has an option to extend the lease for a further 5 years; if the option is exercised the rent continues to increase at 2% per annum and is not re-based to market rent.

The first step in accounting for this lease is to measure the right-of-use asset and the lease obligation by constructing a discounted cashflow.

The Lease Term

The lease term is for a period of 5 years. However, the lessee has an option to extend the lease and this needs to be taken into account. The exposure draft states that the adopted lease term should be “the longest possible lease term that is more likely than not to occur”. It is therefore necessary to

make a subjective judgement as to the likelihood of the renewal option being exercised.

In this example let us assume that the lessee is to spend a considerable sum on fitting out the property and therefore is more likely than not to renew i.e. the probability of renewing is greater than 50%. For the purposes of accounting for the lease it should therefore be assumed that the lease term is 10 years rather than 5.

In some jurisdictions the lessee will have a right to renew a lease as a matter of statute. In such circumstances, even if there is no contractual right to renew, consideration will still need to be given to the likelihood of the lease being renewed.

The Rent Payable

The ED states that the rent to be adopted in the cashflow should be “the probability-weighted average of the cash flows for a reasonable number of outcomes”.

Worked Example 1 - Cashflow and Balance Sheet

Cashflow - £'m										
yr	1	2	3	4	5	6	7	8	9	10
Rent Paid	2.00	2.04	2.08	2.12	2.16	2.21	2.25	2.30	2.34	2.39

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset*	15.48	13.93	12.38	10.84	9.29	7.74	6.19	4.64	3.10	1.55	0.00
Lease Obligation	(15.48)	(14.54)	(13.50)	(12.32)	(11.03)	(9.60)	(8.02)	(6.29)	(4.40)	(2.29)	0.00
Change in Equity**	0.00	(0.61)	(1.12)	(1.48)	(1.74)	(1.86)	(1.83)	(1.65)	(1.30)	(0.74)	0.00

*depreciated cost basis **impact of corporation tax and deferred taxation not modelled

It is therefore necessary to estimate under a number of scenarios (to which probabilities are assigned) the rent which might reasonably be expected to be paid over the term of the lease.

In the case of this example only one scenario needs to be considered since a probability of 100% can be assigned to it as the initial rent is prescribed as are the annual increases throughout the life of the lease. Where this is not the case, for example if the rent reviews were by reference to market rent, a probability based model would need to be built in order to assess a number of possible rent review outcomes.

The Discount Rate

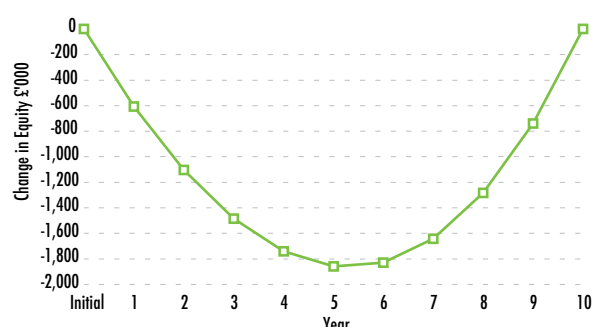
The discount rate to be adopted to discount the cash flows should be “the lessee’s incremental borrowing rate or the rate the lessor charges the lessee, if it can be readily determined”.

In the example the rate the lessor charges the lessee cannot be readily determined since the residual value of the property to the lessor is unknown; therefore the discount rate must be determined from the lessee’s incremental borrowing rate. By incremental the ED means the borrowing rate the lessee would have to pay in order to purchase the asset that is being leased.

Under the ED proposals it can be seen that a very significant asset and liability will be accounted for, furthermore in all likelihood the amount of the liability will exceed the amount of the asset for the entire term of the lease with the difference peaking around the mid-point of the lease, this being the result of the difference between the proposed amortisation methodologies for the asset and the liability.

The resulting mismatch between the right-of-use asset and the lease obligation results in a reduction of equity throughout the lease term as follows:

Balance Sheet – Change in Equity



If rather than the depreciated cost basis the right-of-use asset is accounted for at fair value it may be possible to avoid the mismatch. If IAS 16 fair value accounting is adopted the asset should be re-valued at the balance sheet date. A suitable valuation methodology may be to adopt the same approach as for the initial recognition but effectively rolling the analysis forward to the balance sheet date and assuming that the rent paid should be the market rent at the valuation date rather than the rent actually being paid under the lease. If this analysis is undertaken it will be found that if the market rent is the same as the rent being paid under the lease the right-of-use asset will be equal to the lease obligation and thus the mismatch will be eradicated (assuming that the discount rate is kept constant). If the market rent is higher than the rent being paid the right-of-use asset will be higher than the lease obligation, conversely if the market rent is lower than the rent being paid the right-of-use asset will be lower than the lease obligation.

Worked Example 1 - Income Statement

Income Statement £'m										
yr	1	2	3	4	5	6	7	8	9	10
Amortisation of Right-of-use Asset*	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
Interest Expense	1.06	0.99	0.91	0.83	0.74	0.63	0.52	0.39	0.25	0.10
Total Expenditure	2.61	2.54	2.46	2.38	2.28	2.18	2.06	1.94	1.80	1.65

*depreciated cost basis

The eradication of the right-of-use asset vs lease obligation mismatch through an upward re-valuation of the asset does however have an impact on the income statement as the ongoing right-of-use asset amortisation charge increases significantly.

The ED proposals result in a charge to the income statement that effectively starts high and declines over the life of the lease this being the result of the high interest charge early in the lease and low interest charge in the later years of the lease.

Worked Example 1 – Comparison with accounting under existing IAS 17

The vast majority of occupational leases are currently accounted for as operating leases under IAS 17, indeed many businesses will structure leases so as to ensure that operating lease or “off-balance sheet” accounting treatment is achieved. We have therefore analysed the accounting under the ED proposals in comparison with that currently adopted for operating leases.

The ED proposal has an impact on the balance sheet. Under existing IAS 17 accounting no entries are made in the balance sheet, whereas under the ED proposals a significant asset and liability are accounted for.

Worked Example 1 - Balance Sheet Comparisons

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset IAS 17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Lease Obligation IAS 17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Right-of-use Asset ED*	15.48	13.93	12.38	10.84	9.29	7.74	6.19	4.64	3.10	1.55	0.00
Lease Obligation ED	(15.48)	(14.54)	(13.50)	(12.32)	(11.03)	(9.60)	(8.02)	(6.29)	(4.40)	(2.29)	0.00
Net Difference in Equity	0.00	(0.61)	(1.12)	(1.48)	(1.74)	(1.86)	(1.83)	(1.65)	(1.30)	(0.74)	0.00

*depreciated cost basis

The ED proposals have a significant impact on the income statement.

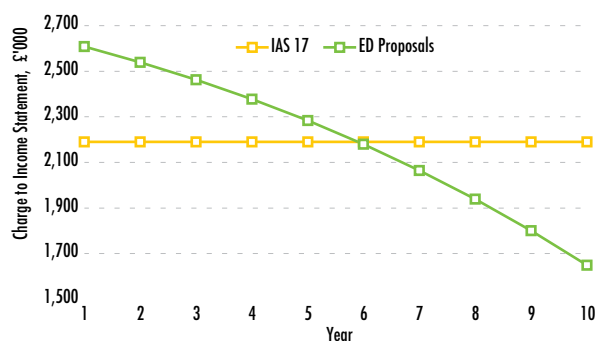
Worked Example 1 - Income Statement Comparisons

Income Statement £'m										
yr	1	2	3	4	5	6	7	8	9	10
Rent Expenditure IAS 17	*2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19
Amortisation of Right-of-use Asset ED**	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
Interest Expense ED	1.06	0.99	0.91	0.83	0.74	0.63	0.52	0.39	0.25	0.10
Total Expenditure ED	2.61	2.54	2.46	2.38	2.28	2.18	2.06	1.94	1.80	1.65
Difference	(0.42)	(0.35)	(0.27)	(0.19)	(0.09)	0.01	0.13	0.25	0.39	0.54

*as rent increases are not contingent straight line basis adopted **depreciated cost basis

Under the proposals the combination of the amortisation and interest expense generate a significantly higher total charge in the early years of the lease but with the situation reversing in the later years. Graphically this can be shown as follows:

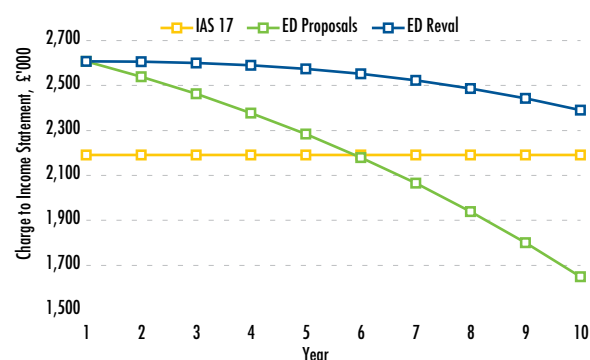
Income Statement – IAS 17 vs ED proposals



As discussed above if IAS 16 fair value accounting is adopted and the right-of-use asset re-valued it may be the case that the mismatch between the right-of-use asset and the lease obligation can be eradicated (subject to actual movement of market rent).

If the right-of-use asset in the example were re-valued annually and the market rent increased exactly in-line with the rent actually being paid under the lease, i.e. at 2% per annum, then the balance sheet mismatch would be entirely eradicated throughout the lease (assuming discount rate is constant). However the impact on the income statement, due to an increase in the right-of-use asset amortisation charge, would be significant, as show below:

Income Statement - IAS 17 vs ED vs ED Reval



WORKED EXAMPLE 2 – COMPLEX EXAMPLE

A Lessee enters into a 15 year lease for a generic office property (i.e. not crucial in its specification for the business) with a net internal area of 100,000 sq ft. The initial rent is £20 per sq ft, £2,000,000 per annum payable quarterly. The rent reviews every 5 years to market rent, upwards only. The lessee

has an option to break the lease at year 5 with a £1,000,000 penalty and at year 10 without penalty.

The inputs to the cashflow are as follows:

The Lease Term

The lease term is for a period of 15 years. However, the lessee has options to break the lease and these need to be considered. The exposure draft states that the adopted lease term should be “the longest possible lease term that is more likely than not to occur”. It is therefore necessary to make a subjective judgement as to the likelihood of the break options being exercised.

In this example let us assume that the lessee is to spend a considerable sum on fitting-out the property and therefore coupled with the break penalty is unlikely to exercise the break option at year 5, we will assume that the probability of the year 5 break being exercised is just 25%. We will assume that by year 10 there is a greater probability of the break option being exercised not least because there is no break penalty and because the property is not crucial to the operation of the business, we shall assume a 40% probability.

The probability of the lease running for 5, 10 or 15 years can thus be summarised as follows:

Probabilistic Approach to Lease Lengths

		5 Year Term	10 Year Term	15 Year Term
A	Year 5 Break Probability	0%	25%	25%
B	Year 10 Break Probability	0%	0%	40%
C	Cumulative Probability (A+B)	0%	25%	65%
	Probability of Term (100% - C)	100%	75%	35%

Therefore the “the longest possible lease term that is more likely than not to occur” is 10 years. The lease should be accounted for as a 10 year lease.

The Rent Payable

The exposure draft states that the rent to be adopted in the cashflow should follow a probabilistic approach to lease length.

It is therefore necessary to estimate under a number of scenarios (to which probabilities are assigned) the rent which might reasonably be expected to be paid over the term of the lease.

As the lease is to be accounted for as a 10 year lease we need, in this example, only consider the rent review that will occur at year 5 as this is the only uncertainty.

The IASB have verbally indicated that a "number" of scenarios could mean 4 or 5 scenarios, so in this example we shall consider 5 possible outcomes, as follows:

Expected Rental Value Approach

Rent on Review £ per sq ft	Rent on Review £ per annum	Probability
*20.00	2,000,000	10%
21.50	2,150,000	15%
23.00	2,300,000	50%
25.00	2,500,000	20%
28.00	2,800,000	5%

*as the review is upward only the rent cannot review to less than the initial rent of £20.00 per sq ft in this example

Worked Example 2 - Cashflow and Balance Sheet

Cashflow - £'m										
yr	1	2	3	4	5	6	7	8	9	10
Rent Paid	2.00	2.00	2.00	2.00	2.00	2.31	2.31	2.31	2.31	2.31

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset	15.22	13.70	12.18	10.66	9.13	7.61	6.09	4.57	3.04	1.52	0.00
Lease Obligation	(15.22)	(14.26)	(13.23)	(12.13)	(10.95)	(9.69)	(8.01)	(6.21)	(4.28)	(2.21)	0.00
Change in Equity	0.00	0.56	1.06	1.48	1.82	2.07	1.92	1.64	1.24	0.70	0.00

*depreciated cost basis **impact of corporation tax and deferred taxation not modelled

Once again the ED proposals result in a charge to the income statement that effectively starts high and declines over the life of the lease this being the

The probability weighted average of the scenarios equals £2,312,500 per annum or £23.125 per sq ft. The cashflow should therefore assume that the rent reviews to £2,312,500 per annum.

The Discount Rate

The discount rate to be adopted to discount the cash flows should be "the lessee's incremental borrowing rate or the rate the lessor charges the lessee, if it can be readily determined".

In the example the rate the lessor charges the lessee cannot be readily determined since the residual value of the property to the lessor is unknown; therefore the discount rate must be determined from the lessee's incremental borrowing rate. By incremental the exposure draft means the borrowing rate the lessee would have to pay in order to purchase the asset that is being leased rather than a general corporate borrowing rate. In practice this may not be easy to determine but for the purpose of this example we will use 7%.

As with Worked Example 1 a very significant asset and liability will be accounted for, and once again the liability will exceed the amount of the asset for the entire term of the lease with the difference peaking around the mid-point of the lease.

result of the high interest charge early in the lease and low interest charge in the later years of the lease.

Worked Example 2 - Income Statement

Income Statement - £'m										
yr	1	2	3	4	5	6	7	8	9	10
Amortisation of Right-of-use Asset	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52
Interest Expense	1.04	0.97	0.90	0.82	0.73	0.63	0.51	0.38	0.25	0.10
Total Expenditure	2.56	2.50	2.42	2.34	2.26	2.16	2.04	1.91	1.77	1.62

Worked Example 2 – Comparison with accounting under existing IAS 17

The ED proposals have no impact on cashflow. While the ED proposals have a significant impact on the balance sheet.

Under existing IAS 17 accounting no entries are made in the balance sheet, whereas under the ED proposals a significant asset and liability are accounted for.

Worked Example 2 - Balance Sheet Comparison

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset IAS17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Lease Obligation IAS 17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Right-of-use Asset ED	15.22	13.70	12.18	10.66	9.13	7.61	6.09	4.57	3.04	1.52	0.00
Lease Obligation ED	(15.22)	(14.26)	(13.23)	(12.13)	(10.95)	(9.69)	(8.01)	(6.21)	(4.28)	(2.21)	0.00
Net Difference in Equity	0.00	(0.56)	(1.06)	(1.48)	(1.82)	(2.07)	(1.92)	(1.64)	(1.24)	(0.70)	0.00

The ED proposals have a significant impact on the income statement.

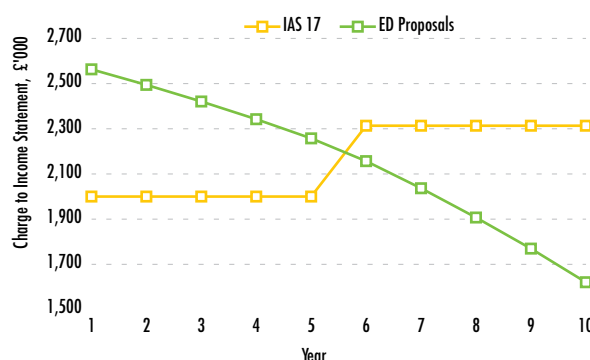
Worked Example 2 - Income Statement Comparison

Income Statement £'m										
yr	1	2	3	4	5	6	7	8	9	10
Rent Expenditure IAS 17	*2.00	2.00	2.00	2.00	2.00	2.31	2.31	2.31	2.31	2.31
Amortisation of Right-of-use Asset ED	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52	1.52
Interest Expense ED	1.04	0.97	0.90	0.82	0.73	0.63	0.51	0.38	0.25	0.10
Total Expenditure ED	2.56	2.50	2.42	2.34	2.26	2.16	2.04	1.91	1.77	1.62
Difference	(0.56)	(0.50)	(0.42)	(0.34)	(0.26)	0.15	0.27	0.40	0.54	0.69

*as rent increase is contingent forecast increase not included in straight line calculation

Under the proposals the combination of the amortisation and interest expense generate a significantly higher total charge in the early years of the lease but with the situation reversing in the later years of the lease.

Income Statement - IAS 17 vs ED Proposals



IMPACT OF CHANGING CASHFLOW VARIABLES

The Lease Term

The lease term has a significant impact on the lease accounting since the longer the lease term the higher the discounted value of the lease payments.

A longer lease term will generally result in a higher right-of-use asset, a higher lease obligation and a higher charge to the income statement during the first half of the lease term.

By way of an example if Worked Example 1 is analysed as two consecutive 5 year terms⁶ versus a single 10 year term the following comparison results.

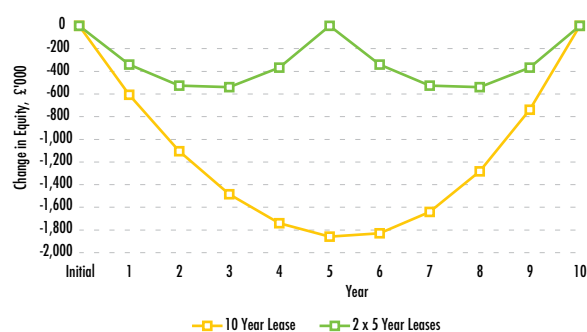
In the modelled scenario the lease term has no impact on the cashflow although it is of course the case that there would in reality be no certainty as to the rent payable from year 6 onwards until the point at which the lease is actually renewed.

Worked Example 2 - Balance Sheet and Lease Term Comparison

Balance Sheet £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset 10 Year	15.48	13.93	12.38	10.84	9.29	7.74	6.19	4.64	3.10	1.55	0.00
Lease Obligation 10 Year	(15.48)	(14.54)	(13.50)	(12.32)	(11.03)	(9.60)	(8.02)	(6.29)	(4.40)	(2.29)	0.00
Change in Equity	0.00	(0.61)	(1.12)	(1.48)	(1.74)	(1.86)	(1.83)	(1.65)	(1.30)	(0.74)	0.00
Right-of-use Asset 2 x 5 Year	8.69	6.96	5.22	3.48	1.74	9.60	7.70	5.76	3.84	1.92	0.00
Lease Obligation 2 x 5 Year	(8.69)	(7.27)	(5.69)	(3.97)	(2.07)	(9.60)	(8.02)	(6.29)	(4.38)	(2.29)	0.00
Change in Equity	0.00	(0.31)	(0.48)	(0.49)	(0.33)	0.00	(0.34)	(0.53)	(0.54)	(0.37)	0.00
Comparison of Net Equity	0.00	0.30	0.64	0.99	1.41	1.86	1.49	1.12	0.76	0.37	0.00

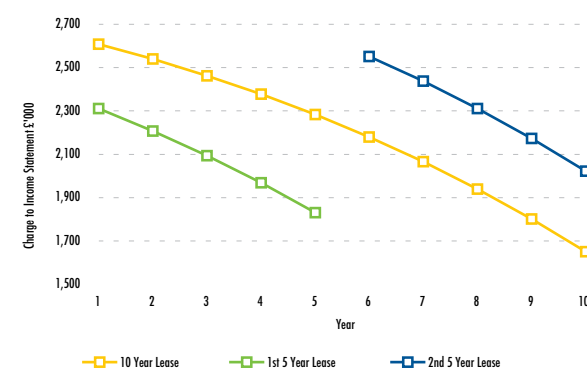
The consecutive 5 year leases result in a significantly better equity position peaking at the end of the first lease when the right-of-use asset is effectively re-valued back up to an amount equivalent to the lease obligation. Graphically this can be seen as follows:

Change in Equity - 10 Year Lease vs 2 x 5 Year Leases



The income statement shows a somewhat more complex situation. Over the term of the first 5 year lease the charge to the income statement is clearly less than under the 10 year lease scenario. During the subsequent 5 year period this situation reverses with the second 5 year lease resulting in higher charges to the income statement although as discussed above the magnitude of these charges will be dependent upon the level of rent agreed on the rent renewal. Graphically the income statement charges are as follows:

Income Statement - 10 Year Lease vs 2 x 5 Year Leases



⁶ The accounting could only take this form if no renewal option existed or the probability of renewing was assessed at less than 50%.

Worked Example 2 - Income Statement and Lease Term Comparison

Income Statement £'m										
yr	1	2	3	4	5	6	7	8	9	10
Total Expenditure 10 Year	2.61	2.54	2.46	2.38	2.28	2.18	2.06	1.94	1.80	1.65
Total Expenditure 2 x 5 Year	2.31	2.21	2.09	1.97	1.83	2.55	2.44	2.31	2.17	2.02
Difference	(0.30)	(0.33)	(0.37)	(0.41)	(0.45)	0.37	0.38	0.37	0.37	0.37

The Rent Payable

It will be self evident that the higher the rent payable the higher the right-of-use asset, the higher the lease obligation and the higher the charge to the income statement. However, given that the proposed ED accounting is based upon a discounted cashflow analysis it is also the case that the timing of the rent payments has an impact, thus the more that the rent payments can be deferred the lower the potential balance sheet and income statement impacts, even if the actual rent payments are higher.

the amount of the right-to-use asset and the lease obligation.

The impact of the discount rate produces the rather odd result that the impact of the ED proposals will be more significant for a lessee with a strong credit rating than for a lessee with a weak credit rating this being somewhat counterintuitive in that it would be expected that the weaker credit lessee would incur higher financing costs and therefore a higher lease obligation than would the stronger credit lessee.

The Discount Rate

The discount rate adopted directly impacts the accounting. The higher the discount rate the lower

By way of an example if Worked Example 1 is reworked with a higher discount rate, say 10%, the impact can be seen as follows:

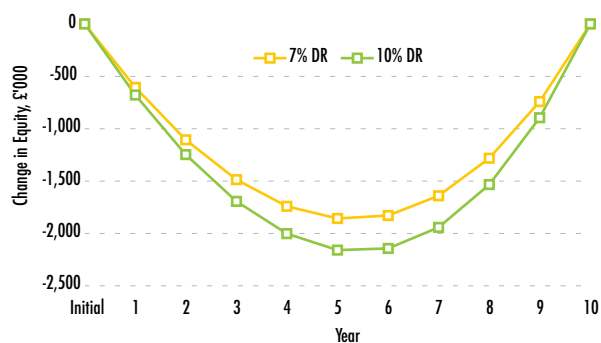
Worked Example 2 - Balance Sheet Discount Rate Comparison

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset 7% DR	15.48	13.93	12.38	10.84	9.29	7.74	6.19	4.64	3.10	1.55	0.00
Lease Obligation 7% DR	(15.48)	(14.54)	(13.50)	(12.32)	(11.03)	(9.60)	(8.02)	(6.29)	(4.40)	(2.29)	0.00
Change in Equity	0.00	(0.61)	(1.12)	(1.48)	(1.74)	(1.86)	(1.83)	(1.65)	(1.30)	(0.74)	0.00
Right-of-use Asset 10% DR	13.53	12.17	10.82	9.47	8.12	6.76	5.41	4.06	2.71	1.35	0.00
Lease Obligation 10% DR	(13.53)	(12.85)	(12.07)	(11.16)	(10.12)	(8.92)	(7.56)	(6.00)	(4.24)	(2.25)	0.00
Change in Equity	0.00	(0.68)	(1.25)	(1.70)	(2.00)	(2.16)	(2.15)	(1.94)	(1.54)	(0.90)	0.00
Comparison of Net Equity	0.00	(0.07)	(0.13)	(0.22)	(0.26)	(0.28)	(0.32)	(0.29)	(0.24)	(0.16)	0.00

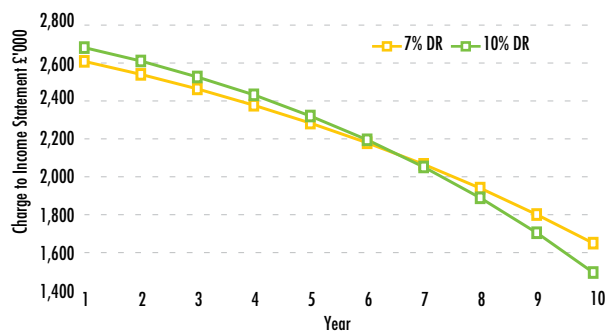
Adopting a higher discount rate reduces the actual amounts of the right-to-use asset and lease obligation throughout the lease term although the change in equity is worse throughout the term if the higher discount rate is adopted.

It is also the case that the higher discount rate is detrimental to the income statement at the least for the first half of the lease.

Change in Equity - 7%DR vs 10%DR



Income Statement - 7%DR vs 10% DR



Worked Example 2 - Income Statement Discount Rate Comparison

Income Statement £'m										
yr	1	2	3	4	5	6	7	8	9	10
Total Expenditure 7% DR	2.61	2.54	2.46	2.38	2.28	2.18	2.06	1.94	1.80	1.65
Total Expenditure 10% DR	2.68	2.61	2.53	2.43	2.32	2.19	2.05	1.89	1.70	1.49
Difference	(0.07)	(0.07)	(0.07)	(0.05)	(0.04)	(0.01)	0.01	0.05	0.10	0.16

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