

Some brief comments on the Lease Accounting Exposure Draft (ED).

1. The ED rightly points out that the leasing business is huge. This is particularly so where property rights are secure and contract enforcement is effective.
2. Why has leasing become so important? The reason is it is an efficient way for entities to manage their operations. Leasing is more likely with certain classes of “generic assets”. Examples are assets on wheels (aeroplanes, cars, trucks, buses etc.) and other general purpose assets like computers, copying machines, and floor space). Whereas specialised assets are more likely to be owned, general purpose assets are more likely to be leased. Further, it is not uncommon for the lease payment to include a maintenance component. In sum, leasing is often the lowest transaction cost solution to an entity in managing its operations. As just one illustration, our University (which is subject to IFRS in this jurisdiction) leases thousands of assets.
3. One fairly recent phenomenon is the growth of shopping centres. In that space, contracts have evolved which are suitable for both lessors and lessees. As is well known lessees pay rent for space, and rent based on revenue. That latter component binds the interests of the two parties together in an efficient arrangement.
4. So-called operating leases also have the nice property that the accounting is simple and certain.
5. The ED asserts that the benefits of the ED outweigh the costs. The Basis for Conclusions (BC) has some statements about how this conclusion was reached. These statements are vague and light-weight and give the reader no detailed sense of how that work was undertaken.
6. I also have done some enquiries and have reached the opposite conclusion. For our own institution (for example) I have no doubt that the gross benefits of capitalising all our leases are close to zero, and the costs are huge.
7. In talking to retailers about their expenses, it is clear that they see rent as an operating cost, in exactly the same way as they see wages as an operating cost. In their internal analyses they subtract “rent” as a cost before determining “operating cash flow” or “operating profit”. They do not see part of rent as a “financing cost”.
8. One reason for this is that they are not looking at the lease as a “lease or buy” decision. The reason is obvious – they cannot buy their floor space. This means that in their decision making they do not use either (a) an incremental borrowing rate (as it’s irrelevant in this context), or the interest rate implicit in the lease (as there is no initial cost to be allocated and similarly no residual value to be determined). The correct rate to use in a discounted cash flow formulation would be the weighted average cost of capital. The ED does not acknowledge that.
9. In sum, the big error being made throughout the ED is the formulation of the problem as if it’s a financing problem, when a lot of the time it is not – it’s an (efficient) operating problem.
10. There are undoubtedly cases currently whereby organisations have contrived to create an agreement as an “operating lease” where the substance is that of (what is currently called) a “finance lease”, and exploited the current accounting rules as a consequence. That’s unfortunate but the elimination of this distinction is even more unfortunate, and to load the costs of the new ED to “catch” some perceived offenders is an extremely weak justification.

Even then, it's not clear what if any damage has been done by the contrivances referred to above.

11. I have read some of the summaries prepared by the large accounting firms on this topic. By and large they are not overly critical. I don't find this surprising if one considers their self-interest in this matter. However, when one reads these documents carefully what becomes apparent very quickly are the huge difficulties associated with implementation and interpretation. This ED, if it becomes a Standard, will likely induce the same degree of angst as has occurred with the Financial Instruments Standards. At least with IAS 39 there was a stronger case for putting items on balance sheets that were "off balance sheet". Here there is a very great danger associated with putting items on balance sheets and deconstructing those items later (into depreciation and interest from the lessee's perspective) which is (in many cases) completely inconsistent with the way the managers of those assets see them within the context of their own organisations.
12. Further, my discussions with company directors, including many member of the accounting profession, reveals a growing disquiet with IFRS. If the disquiet is palpable in the backwater that is New Zealand, I imagine it is likely to be much more intense in some of the big commercial centres of the world. The danger here is that proceeding with this ED may permanently damage the good (in many people's view) idea of having a sensible set of international financial reporting standards.
13. I attach a short piece that I had prepared for another purpose. There is a "warning" in the top line.

David Emanuel

Department of Accounting and Finance

University of Auckland

Private Bag 92 019

Auckland 1142

NEW ZEALAND

d.emanuel@auckland.ac.nz

Citizen A and Citizen B (To be taken as seriously as you want to)

Citizen A and citizen B (A and B hereafter) live in an idyllic south pacific island paradise. The island is called Nowhere (Nw). They live on opposite ends of the island (A in the east and B in the west) in identical houses with similar lagoons, land quality and water resources. Apart from A and B's identical families, the only other inhabitant of the island is D*g, the island's governor, who lives in a hut on the south side of the island. He is a mystical non-intervening type and A and B sometimes wonder if he exists. All D*g does is receive annual statements of financial position from A and B each year, which he aggregates. That gives him a sense of the state of the island's affairs.

Nw is an open economy, although trade is currently non-existent. As an open economy and because it was thought that subscribing to international financial reporting standards would demonstrate some high quality governance characteristics, D*g had signed Nw up with the IASB to apply best practice accounting. D*g was pleased with this.

A and B's houses had balance sheet values of CU (currency units) 1,000,000. Neither A nor B had any debt. D*g had no knowledge of what A and B did – he simply received IFRS accounts each year and aggregated them. The last set of accounts when aggregated showed assets of CU2,000,000 and no debt. D*g slept well.

One day A and B met in the middle of the island and agreed that they needed a change. A agreed to lease B his house, and B did similarly. They agreed that the rent should be 5% of the initial value, paid annually in arrears.

A went home and consulted the international financial reporting standards. They informed him he, as a lessor, had two assets – a house and a lease agreement. He understood that, but now the issue was to determine a value for the leased asset. As this was an extremely long term lease he figured that the best estimate of the amount to assign as his lessor's interest was CU1,000,000. He then decided his lease liability must be the same amount.

But what did that do to the value of the other asset, his house, which he still owned. He decided to read the Basis for Conclusions (BC) for the Lease Standard and he discovered the following paragraph part of BC 16:

“When the lessor grants the lessee the right to use the underlying asset during the lease term in exchange for a right to receive lease payments from the lessee it does not lose

control of the underlying asset and, thus, continues to recognise the underlying asset in the statement of financial position, with no adjustments.”

Well, then, I must now have CU2,000,000 of assets and CU1,000,000 of liabilities on my balance sheet. Now can I offset the liability against the asset, he asked? He was finding reading these Standards a challenge, as he had just finished reading IAS 39. He decided that for the moment he would not offset these items.

A thought a while. Then he realised he had another asset. He was a lessee and he had the right to occupy B’s house. The question then was – what value should he assign to his new asset? Once again, he came to the conclusion that an appropriate value was CU1,000,000. And he also realised that he had an “offsetting” liability – he had to pay for the lease. He looked at his balance sheet again. He now had CU3,000,000 of assets and he felt good. But then he noticed he had CU2,000,000 of liabilities and a debt/equity ratio of 200%. This worried him as he was told he would never be able to borrow any funds if debt was greater than about 60% of his assets.

So A prepared his new balance sheet, CU3,000,000 of assets and CU2,000,000 of liabilities and the same equity that he had before.

While A was doing this, B was doing likewise and B duly completed his accounts. He was amazed to find his assets had trebled and his liabilities had increased by...an infinite amount. From zero to CU2,000,000.

They then submitted their new IFRS compliant accounts to D*g, who duly aggregated them. He discovered that the island now had assets of CU6,000,000 and liabilities of CU4,000,000. D*g was deeply worried. No longer did he sleep well.