

IFRS industry insights

Real estate implications of the revised leasing exposure draft

The bottom line

- A revised exposure draft on lease accounting has been published by the IASB with a comment deadline of 13 September 2013.
- Lessors will keep most properties entirely on balance sheet and can continue to carry properties at fair value.
- Leases that could extend beyond 12 months will come on-balance sheet for lessees, potentially impacting key performance indicators, gearing and lending covenants.
- For lessees most property leases will have an overall straight-line expense profile, but many other leases will have a front-loaded expense.

What's happened?

The IASB has published a revised exposure draft (the 'ED') on lease accounting with comments requested by 13 September 2013. Whilst a number of problems identified by respondents to the exposure draft published in 2010 (such as the definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities undoubtedly remain. What is clear is that accounting for leases may prove time consuming and will inevitably require judgements to be made.

Implications for the real estate industry

This publication highlights three issues from the latest proposals that will be of particular interest to those in the real estate industry, both from a landlord's and a tenant's perspective. Of course many more complexities exist and, as described below, Deloitte has produced further guidance, exploring these in greater detail.

Most properties could stay at fair value on lessors' balance sheets

Although the previously proposed exemption for investment property lessors has been removed, unless a property is leased for the "major" part of its remaining economic life or the lease payments are "substantially all" of its fair value (such cases are expected to be rare) lessors would retain the entire underlying asset on their balance sheet. Such investment properties could then be measured at fair value with income recognised in a similar fashion to existing operating leases. Whilst this may be a straight-forward exercise it will nonetheless require lease-by-lease analysis and supporting documentation. For instance, careful scrutiny will be required to determine whether, in effect, the lease term is for a major portion of the asset's economic life. Other properties would be replaced on the balance sheet by a receivable for lease payments and a residual asset recoverable at the end of the lease. Most impacted by the latter approach would be landlords operating longer leases on buildings with limited expected useful economic lives such as near end-of-life distribution centres or industrial property.

Estimating the value of residual assets at lease commencement may prove onerous and require considerable judgement, with system upgrade potentially being required for their accounting. The proposed requirements are complex and include estimating expected variable lease payments at the commencement of the lease in order to estimate the residual asset. Over the lease term the residual asset is accreted for the unwinding of the discount and adjusted for the expected pattern of variable rentals.

Leases coming on balance sheet for lessees

Lessees would recognise an asset and corresponding liability on their balance sheets for their fixed future lease payments, similar to existing finance lease accounting. Aside from a few specific scope exclusions, the only other leases that could stay off-balance sheet would be those that have a maximum possible term of 12 months, including a presumption that extension options will be exercised.

Few investors in traditional property on typical lease terms will be required to change their approach

The biggest leases for many lessees will be properties

Lessees recognise a straight-line expense for most property leases but front-loaded for many other assets

For most property leases, subsequent measurement of a lessee's asset and liability would yield a straight-line single lease expense. The same test described above would be applied for assets other than property, such as vehicles and office equipment, but a lower threshold of "insignificant" would need to be met and the asset's total economic life considered. Otherwise, the expense profile would be front-loaded because the lease asset would be amortised on a straight-line basis, whilst the lease liability would be amortised using the effective interest rate method.

Leases other than property will require significant analysis by all

Areas impacted by the proposals	
Lease term	The impact of lease liabilities coming on balance sheet for tenants may increase the pressure for shorter, more flexible leases in order to minimise the balance sheet impact whilst still meeting operational requirements.
Staff resourcing	Adequate staff resource, appropriately trained, would need to be made available to enable an assessment of lease classifications under the new model. Estimating residual values for the few property leases where this would be required may prove onerous and highly judgmental.
Reporting systems	Systems would need to capture all information required by any new standard – the ED proposes extra disclosures beyond those currently required. Closer relationships between finance teams and the operations teams entering into leases may be advisable to avoid undesired accounting consequences.
Banking covenants	Initial recognition of an asset and liability may not have an impact on a lessee's net assets, but it could affect key balance sheet ratios, particularly if the liability is treated as a financing item. For leases with front-loaded expense profiles, any interest expense beyond that on existing finance leases could impact covenants based on interest cover. Covenant renegotiations could be required.
Key performance indicators	Key metrics of a business' performance could be impacted by the proposals. Depending on how they are calculated, measures such as return on capital may be affected or need redefining. For those operating lease expenses that would be replaced with a front-loaded interest and amortisation charge, adjusted measures of lessees' earnings which strip out the effect of interest, such as EBIT, may increase and those that strip out amortisation and depreciation as well, such as EBITDA, could increase by a greater amount.
Tax	The potential impact of the proposed lease accounting changes on cash tax and deferred tax would need to be reviewed by reference to tax legislation in each relevant jurisdiction.

Resources

More detailed information on the revised ED can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. You can also register on IASPlus to receive newsletters that provide updates whenever the leasing project is discussed at IASB meetings. The revised exposure draft itself can be accessed on the IASB website at www.iasb.org.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2013 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 26513A