W ith skyrocketing real estate prices in Hong Kong, a common management decision usually driven by economics is whether to lease or to buy. Another consideration is the impact the transaction will have on financial ratios that measure company performance and stock prices.

Entering into operating leases is generally preferred to buying on long-term instalments. The former results in better investment returns and lower leverage ratios.

However, some advantages of operating a lease may soon disappear. Almost a decade has passed since Sir David Tweedie, recently retired chairman of the International Accounting Standards Board, joked with a dinner audience that no one in the room had ever flown on an aircraft that appeared on the airline’s balance sheet. His comments prompted the IASB and the U.S. Financial Accounting Standards Board to propose bringing the rights and obligations associated with a lease onto the lessee’s balance sheet as assets and liabilities. The two boards began a joint project in March 2009 to explore the option.

To address this criticism, the IASB released an exposure draft on 17 August 2010 intended to replace IAS 17. After a very active feedback round, the boards tentatively decided to make significant changes to the original exposure draft. The revised proposals will be re-exposed for a second round of consultations later in 2011.

The exposure draft proposes a single model to account for all leases, which effectively ends the off-balance sheet treatment of operating leases. Under the proposal, all lease rights and obligations are recognized from the commencement of the lease agreement. The exposure draft covers both the lessor and lessee, bringing about significant accounting change for both parties.

**Lessee accounting: right-of-use model**

The biggest impact of the exposure draft’s proposed changes is probably on lessees, especially on existing and future operating leases.

Under the proposed rules, the lessee will record a financial liability and a corresponding right-of-use asset at the start of the lease. The financial liability will be measured at the present value of the expected cash flows, discounted using the lessee’s incremental borrowing rate. This liability will be carried at amortized cost with interest accounted for using the effective-interest-rate method.

On the other hand, the right-of-use asset, which represents the right of the lessee to use the asset over the lease term, is separately shown on the balance sheet as part of property, plant and equipment. The right-of-use asset is subject to amortization and impairment testing.

In the original exposure draft, the lease will initially be measured based on the estimates of the lease term and lease payments. These estimates need to be reassessed at each reporting date. Any resulting change would impact either the right-of-use asset or liability, which in turn affects profit or loss.

The definition of the lease term in the original exposure draft was the longest possible lease term that has more than a 50 percent probability of occurring. This is now defined as the non-cancellable period plus any options where there is a significant economic incentive to extend or maintain the lease arrangement. This new definition would typically shorten the lease term and therefore reduce the amount recognized on the balance sheet.

The original exposure draft required lessees to recognize all leases on the balance sheet and allowed for some simplification for short-term leases. The boards have now tentatively decided to allow companies to apply current lease accounting to short-term
leases. Therefore, companies would not be required to recognize lease-related assets and liabilities for short-term leases.

Taking into account expected lease payments – such as contingent rentals, penalties and residual value guarantees – it was suggested that reporting figures entailed by the original exposure draft could be speculative and might not represent present obligations on the balance sheet.

In the re-deliberations, the boards instead suggested that contingent payments based on performance and usage be recognized as expenses as they are incurred, which reduced the amounts recognized on the balance sheet.

**Business implications for lessees**

For lessees, the most visible impact of the exposure draft’s proposed changes would be the “grossing up” of the balance sheet to include amounts that are off the balance sheet under the current lease accounting standards. Instead of being recognized as a rental expense over the lease period under the operating lease model, leases will now be recognized upfront as an asset. As a result of the on-balance sheet treatment, some debt-to-equity ratios may deteriorate even if cash flow and business activities stay the same.

For certain regulated financial institutions – such as banks, securities companies and insurers in Hong Kong – the additional asset booking might attract capital charges depending on how regulators such as the Hong Kong Monetary Authority, the Securities and Futures Commission and the Office of the Commissioner of Insurance react to the proposed changes. In addition, the lease expense would be replaced by an interest expense on the financial liability and the right-of-use asset would have a depreciation expense. Both could make a difference to the amount of corporate income taxes levied by the Inland Revenue Department.

While debt coverage ratios will suffer, earnings before interest and tax or earnings before interest, taxes, depreciation and amortization are likely to improve. However, the reassessment of lease cash flows on an ongoing basis will also result in volatility in net assets and income. Finally, operating cash flows will improve because lease payments will now be recognized under both performance obligation and de-recognition models as receivables at the inception of the lease. Accordingly, the balance sheet will grow under the performance obligation model and financial ratios will change.

These changes could affect loan covenants, financing deals and even regulatory requirements. Companies providing remuneration incentives may also need to reassess whether some formulas used in reward calculations remain appropriate.

Since the exposure draft would require continuous reassessment of lease assumptions, a company may need to establish policies and design processes and controls to ensure that reliable input from departments is promptly gathered, analysed and processed.

Companies should also consider whether their management information systems are sufficient. Some may choose to customize their systems while others may choose to buy software developed once the exposure draft advances to a final standard.

The changes proposed in the exposure draft will also affect the structuring of lease contracts. For instance, shorter leases will have a smaller impact on the balance sheet and on the long-term volatility of financial statements, and vice versa for larger leases.

However, a leased asset or liability may still be required to reflect the impact of renewal option periods. If options are not included, the lessee is likely to be concerned about the security of asset, especially with Hong Kong’s escalating real estate rental prices. Lessees should balance the financial statement implications of short-term leases with the cost of constantly renewing these arrangements.

Certain industries such as independent power producers and semiconductor companies have build-operate-transfer, build-operate-own or similar contracts that may contain lease arrangements now classified as operating leases. Under the exposure draft, these contracts should be revisited and may result in “grossing up” the balance sheet. Given the context under which these contracts are entered into – that is, long-term project finance-type infrastructure projects – any “grossing up” of balance sheet line items will probably affect sensitive financial ratios of existing loan covenants.

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**Lease accounting**

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**Lessor accounting: performance-obligation model**

Two models are being proposed for lessors. For leases that do not substantially transfer the risk and rewards related to the underlying assets, the lessor will apply the performance-obligation model.

This model assumes that the asset remains an economic resource of the lessor; hence it is retained in the lessor’s books. This asset will be depreciated over its useful life and subject to impairment testing.

The performance-obligation model also requires that the lessor initially records a lease receivable net of any initial direct cost, calculated at the present value of expected lease charges over the lease term. This asset is carried at amortized cost with interest being recognized using the effective-interest-rate method. It also requires the lessor to record a performance obligation liability initially equal to the amount of the recorded receivable. The amount is then subsequently amortized on a systematic basis—usually straight-line—as lease revenue over the lease term.

Since the lease receivable and related liability are initially measured based on expected cash flows specified in the lease agreement, the lessor is required to reassess the receivable’s carrying amount if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period. This is expected to create volatility in the financial statements.

Under the performance obligation model, the balance sheet will reflect the following line items: the leased assets as property under lease, plus the lease receivable less the amount of performance obligation. This will result in either a net asset or net liability.

**Lessor accounting: de-recognition model**

For other leases, where the risks and rewards are presumed to have been substantially transferred to the lessee, the lessor will apply the de-recognition model.

The lessor will de-recognize the underlying asset and recognize a lease receivable and a residual asset representing the portion of the underlying leased asset that is retained with the lessor. This residual asset represents an allocation of the carrying value of the leased asset. It is based on the relative fair value of the residual asset to the fair value of the underlying asset calculated at inception of the lease. The allocation requires a considerable degree of judgment and estimation.

Similar to the performance-obligation model, the lessor will record a lease receivable. The receivable is calculated as the present value of the expected lease charges net of initial direct costs with interest accounted for using the effective-interest-rate method.

After initial recognition, the lessor is required to reassess the lease term if there is any indication of change. The effect of such reassessment results in an adjustment to the fair value guarantees, with resulting changes recognized in profit or loss.

On the balance sheet, the lessor is required to separately present as assets the lease receivable and the residual asset which is presented as part of property, plant and equipment.

**Business implications to lessors**

As lessees might prefer short-term leases, lessors would bear the risks of higher financing costs and non-renewal of short-term contracts. In an effort to cushion the effect of the exposure draft, some companies may consider modifying existing lease contracts while others may explore buying assets instead.

The lease will initially be measured based on the estimates of the lease term, contingent rentals, penalties and residual value guarantees. These estimates need to be reassessed at each reporting date. Any resulting change would impact either the right-of-use asset and liability, which then affects profit or loss.

Similar to lessees, lessors’ re-measurements relating to the estimates of the lease term, contingent rentals, penalties and residual value guarantees are expected to create volatility in financial statements.

Certain lessors specializing in operating leases, such as car leasing companies, may have to review business models as customer or lessee preference may shift given the proposed on-balance sheet recognition of all leases.

**Conclusion**

As entities structure new leases or modify existing ones in light of the new exposure draft, current and deferred tax implications should be considered now that we have the new exposure draft. Assessing tax implications early would help companies reduce tax risks from the IRD.

The boards plan to issue the second exposure draft in the fourth quarter of 2011 and publish a final standard in 2012. It is expected that the proposed standard will be applied to all leases existing as of the date of initial application. If the proposed standard takes effect in 2013, then all leases outstanding as of 1 January 2012 will have to be reviewed.

This might present a significant challenge as some leases are already long outstanding. Some entities do not maintain a repository of contracts that can provide the necessary information needed for the transition. Entities should consider gathering lease related information on a systematic and real-time basis.

However, the proposed on-balance sheet treatment is likely to be permanent. Companies are therefore strongly encouraged to conduct an early impact assessment of the exposure draft.

Understanding the exposure draft better will help firms prepare and plan for the transition in a way that will help address accounting, tax, regulatory, process and system concerns.

In light of the proposed on-balance sheet treatment of all leases, how is the line drawn between a leased asset and an owned one, from a financial reporting perspective? With IAS 17, firms classify leases either as an operating or a finance lease, given that the standard provides qualifying rules to allow an off-balance sheet treatment of operating leases. With the exposure draft, such a distinction will disappear along with many lease structuring opportunities such as sale leaseback transactions.

The World Leasing Yearbook 2010 identified global leasing exposures in 2008 as US$640 billion. This figure is not limited to firms with obvious large exposures to big-ticket items such as property and aircraft. It also includes large accumulated exposures to much smaller items such as vehicles and office equipment.

When the new standard comes in effect, will it be better to lease or to buy? There might not be much difference after all.

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