

# The future of leasing\*



PricewaterhouseCoopers (PwC) provides industry-focused assurance, tax, human resource and advisory services to build public trust and enhance value for our clients and their stakeholders. Together with 4,900 colleagues in the Netherlands and more than 163,000 people in 151 countries around the world, we share our thinking, experience and solutions to develop fresh perspectives and practical advice.

'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited. Each member firm is a separate and independent legal entity.

# 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.

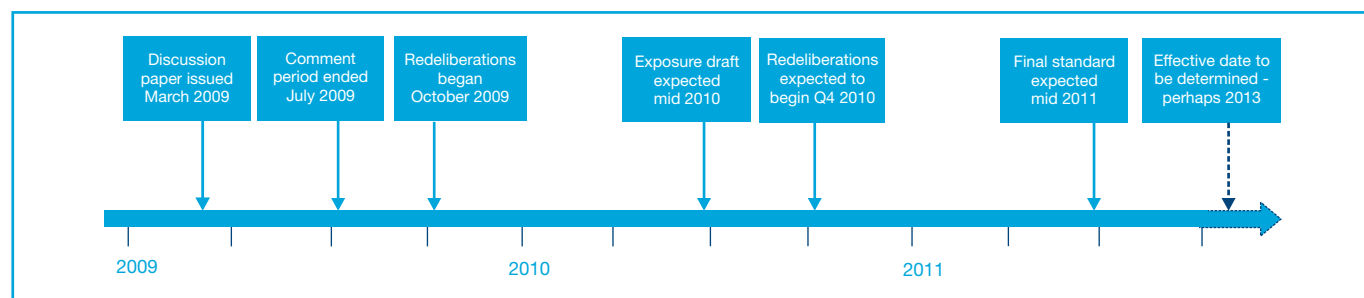
The IASB and FASB have been working to create a single, global leasing standard as part of their global convergence process and building on previous work contained in the 1999/2000 discussion paper entitled 'G4+1 Special Report: Leases: Implementation of a New Approach'. They issued a joint discussion 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.

## 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 will include optional extension periods.
- Contingent rentals and residual value obligations 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.

## Timeline



# 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, 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 financial 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 and bonus 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 standard 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.

In some jurisdictions IFRS principles and/or IFRS financial statements may be relevant for determining certain tax thresholds (e.g. the Netherlands). 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
  - transport and logistics
  - healthcare
  - professional and other services
  - telecoms
  - 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.





# Appendix



# PricewaterhouseCoopers' benchmark study

**Research completed by PricewaterhouseCoopers and the Rotterdam School of Management, the Netherlands has quantified the impact of the proposal for lease accounting on financial ratios reported by 3,000 companies worldwide. The expected minimum impact of the proposed changes to lease accounting is that the reported interest bearing debt, leverage and EBITDA by companies will increase, for certain companies this increase will be substantial.**

## Summary of research results

In March 2009, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued a Discussion Paper proposing a new model that would significantly change lease accounting for lessees, including the elimination of operating leases. Under this proposal, the current distinction between operating leases and finance leases will be eliminated and all leases will be accounted for on balance including existing operating leases that are now accounted for off balance. The comment period for the Discussion Paper ended on July 17, 2009. 300 comment letters were received. Since then, the boards are evaluating the feedback received and expect to release an exposure draft in mid-2010 and a final standard in 2011.

Research completed by PricewaterhouseCoopers and the Rotterdam School of Management, the Netherlands has quantified the minimal impact of the proposal on financial ratios reported by companies worldwide. Based on the operating lease disclosures in financial statements of some 3,000 companies worldwide, they expect that the reported interest bearing debt of these companies will increase with an average of 58%. This is a cautious estimate as only the impact of capitalizing disclosed operating leases is quantified in the research. The impact on companies' debt can be higher depending on the specific details in a final standard. The average impact on debt balances is influenced by a number of companies that will see a large relative increase in debt. Nevertheless, 24% of the companies will see an increase in their debt balances of over 25% based on this research.

The research also shows that the impact on financial ratios differs significantly per industry. Industries that will see the highest impact on reported financial ratios are:

- Retail and Trade;
- Professional and Other services;
- Transport and Warehousing;
- Accommodation; and
- Telecom.

For retail companies, the reported debt balances are expected to increase by an average of 213% and the leverage (calculated as interest bearing debt divided by equity) will increase by an average of 64 percentage points. Approximately 71% of the retail companies will see an increase of reported debt balances of over 25%.

The following table includes a summary of the average

impact per industry:

| In % except for leverage       | Average increase in interest bearing debt | % companies with over 25% increase | Average increase in leverage (percentage points) | Average increase in EBITDA |
|--------------------------------|---|------------------------------------|--|----------------------------|
| Retail and Trade               | 213                                       | 71                                 | 64   | 55                         |
| Other Services                 | 51  | 35                                 | 34   | 25                         |
| Transportation and Warehousing | 95  | 38                                 | 31   | 44                         |
| Telecom                        | 23  | 21                                 | 20   | 16                         |
| Professional Services          | 158                                       | 52                                 | 19   | 27                         |
| Amusement                      | 25  | 18                                 | 19   | 13                         |
| Accommodation                  | 101                                       | 41                                 | 18   | 30                         |
| Wholesale Trade                | 34  | 28                                 | 17   | 21                         |
| <b>All companies</b>           | <b>58</b>                                 | <b>24</b>                          | <b>13</b>  | <b>18</b>                  |
| Manufacturing                  | 50  | 21                                 | 9  | 13                         |
| Construction                   | 68  | 20                                 | 8  | 14                         |
| Oil, Gas and Mining            | 30  | 16                                 | 7  | 10                         |
| Financial services             | 27  | 11                                 | 6  | 15                         |
| Utilities                      | 3   | 3                                  | 2  | 6                          |

Certain companies have limited debt balances / low leverage. As a consequence the impact of capitalization of operating lease commitments has is relatively high. These outliers have

a large impact on the calculation of the average increases for financial ratios. As a consequence, the medians are also reported below, as these are not influenced by the outliers:

| In % except for leverage       | Increase in interest bearing debt | Increase in leverage (percentage points) | Increase in EBITDA |
|--------------------------------|-----------------------------------|--|--------------------|
| Median <sup>1</sup>            |                                   |  |                    |
| Retail and Trade               | 64                                | 42                                       | 34                 |
| Other Services                 | 16                                | 17                                       | 13                 |
| Professional Services          | 28                                | 12                                       | 20                 |
| Transportation and Warehousing | 14                                | 9  | 14                 |
| Telecom                        | 9                                 | 8  | 7                  |
| Wholesale Trade                | 13                                | 8  | 11                 |
| Accommodation                  | 12                                | 6  | 10                 |
| Manufacturing                  | 9                                 | 5  | 7                  |
| <b>All companies</b>           | <b>8</b>                          | <b>4</b>                                 | <b>7</b>           |
| Construction                   | 3                                 | 4  | 6                  |
| Amusement                      | 5                                 | 4  | 5                  |
| Financial services             | 3                                 | 2  | 5                  |
| Oil, Gas and Mining            | 3                                 | 1  | 2                  |
| Utilities                      | 0                                 | 0  | 3                  |

<sup>1</sup> This means that 50% of the companies have a higher impact and 50% a lower impact. The median is less influenced by outliers than the average.

The research also shows that the impact on individual companies within an industry can be significantly different depending on the size of the company and country of residence. Companies in the Netherlands are expected to see an average increase in leverage of 27 percentage points which is the largest increase.

This may result in a competitive disadvantage for companies in the Netherlands compared to their peers in other countries.

The following table includes the average increases for a selection of key countries:

| In % except for leverage | Average increase in interest bearing debt | % Companies with more than 25% increase | Average increase in leverage (percentage points) | Average increase in EBITDA 2008 |
|--------------------------|---|---|--|---------------------------------|
| Netherlands              | 111                                       | 35                                      | 27   | 27                              |
| United Kingdom           | 110                                       | 42                                      | 20   | 24                              |
| Italy                    | 42  | 18                                      | 20   | 30                              |
| France                   | 27  | 36                                      | 20   | 31                              |
| Sweden                   | 68  | 33                                      | 17   | 21                              |
| Germany                  | 84  | 33                                      | 16   | 18                              |
| United States            | 34  | 19                                      | 15   | 15                              |
| <b>All companies</b>     | <b>58</b>                                 | <b>24</b>                               | <b>13</b>  | <b>18</b>                       |
| Switzerland              | 100                                       | 34                                      | 12   | 28                              |
| Singapore                | 48  | 28                                      | 8  | 20                              |
| Hong Kong                | 75  | 19                                      | 7  | 18                              |
| China                    | 41  | 18                                      | 5  | 13                              |
| Japan                    | 187                                       | 19                                      | 2  | 30                              |

In the following table the median is presented for the increases per country. This median is less influenced by outliers than the average:

| In % except for leverage | Increase in interest bearing debt | Increase in leverage (percentage points) | Increase in EBITDA 2008 |
|--------------------------|-----------------------------------|--|-------------------------|
| Median <sup>2</sup>      |                                   |  |                         |
| Netherlands              | 16                                | 12                                       | 12                      |
| France                   | 18                                | 10                                       | 22                      |
| United Kingdom           | 19                                | 9  | 11                      |
| Sweden                   | 11                                | 7  | 12                      |
| Germany                  | 12                                | 5  | 10                      |
| United States            | 7                                 | 5  | 7                       |
| Switzerland              | 15                                | 4  | 10                      |
| <b>All countries</b>     | <b>8</b>                          | <b>4</b>                                 | <b>7</b>                |
| Italy                    | 4                                 | 4  | 11                      |
| Singapore                | 9                                 | 3  | 7                       |
| Hong Kong                | 3                                 | 1  | 4                       |
| Japan                    | 3                                 | 1  | 14                      |
| China                    | 2                                 | 1  | 2                       |

<sup>2</sup> This means that 50% of the companies have a higher impact and 50% a lower impact. The median is less influenced by outliers than the average.

The proposal will also result in an increase of EBITDA (Earnings Before Interest Tax Depreciation and Amortization). EBITDA is expected to increase as rent expense will be replaced with interest and amortization expense, which are below-the-line charges. The companies in the research will see an average increase in EBITDA of 18%. For companies in the Netherlands this advantage is slightly higher and amounts to 27%. The economic downturn resulted in a lower 2008 EBITDA for many companies. As a result, this increase in EBITDA might not be representative for the actual increase upon a final standard.

Analysts, credit agencies and banks currently adjust financial statements for off balance operating leases using various rules of thumb. A frequently used rule of thumb to estimate the lease liability and to adjust financial statements is based on a multiple of 7 applied to the annual rent expense. This rule of thumb is based on an average remaining lease term of approximately 7 years. Whether this rule of thumb, as an approximation of the lease liability used to adjust financial statements for off balance operating leases, is reliable can only be concluded upon issuance of a final standard. Companies' stock prices and access to capital may be impacted if the conclusion is that the rule of thumb historically used was not reliable in estimating the actual adjustment to the financial statements.

The research compared the adjustment to companies' debt as a result of capitalization of off balance operating leases with the results of the rule of thumb. This comparison shows that for 93% of the companies the rule of thumb of 7 times the rent expense resulted in an overstatement of debt balances. However, the actual impact on financial ratios will depend on the details in a final standard for lease accounting.

The following table presents a summary of the percentage of companies per Industry for which the rule of thumb overstates the adjustment for capitalization of operating leases:

| In %                           | % companies for which the lease liability is lower than rule of thumb of 7x rent expenses |
|--------------------------------|---|
| Accommodation                  | 22  |
| Retail and Trade               | 15  |
| Transportation and Warehousing | 13  |
| Oil, Gas and Mining            | 12  |
| Financial services             | 11  |
| Telecom                        | 7   |
| <b>All companies</b>           | <b>7</b>  |
| Construction                   | 7   |
| Other Services                 | 6   |
| Professional Services          | 5   |
| Amusement                      | 5   |
| Wholesale Trade                | 5   |
| Manufacturing                  | 5   |
| Utilities                      | 5   |

A final standard may likely require lease capitalization based on a lease term that is longer than the contractual lease term (i.e. 'longest possible lease term that is more likely than not to occur'). This might tend to lengthen the accounting lease term beyond that determined under existing lease accounting standards. The resulting adjustment to financial ratios for off balance operating leases might be significantly higher under this approach to determining the accounting lease term. In this scenario, the adjustment to companies' debt will increase and may even be higher than the rule of thumb. Companies that will report a larger increase in debt than the rule of thumb applied by analysts, credit agencies and banks should be concerned, especially if their peers in the industry are not.

The financial industry generally acts as lessor. The economic benefits of leasing will not change as a result of the proposed lease accounting. Lessors will need to emphasize the continued economic benefits of leasing as well as address the potential practical consequences for lessees.

### Summary of research approach

The research is based on the 2008 financial statements of over 3,000 listed companies in 54 countries worldwide. Companies with a negative equity or companies with a market cap of less than USD 50 million were excluded from the research. Also, the outliers for the most important variables are excluded. After this exercise a dataset remains for 2,795 companies.

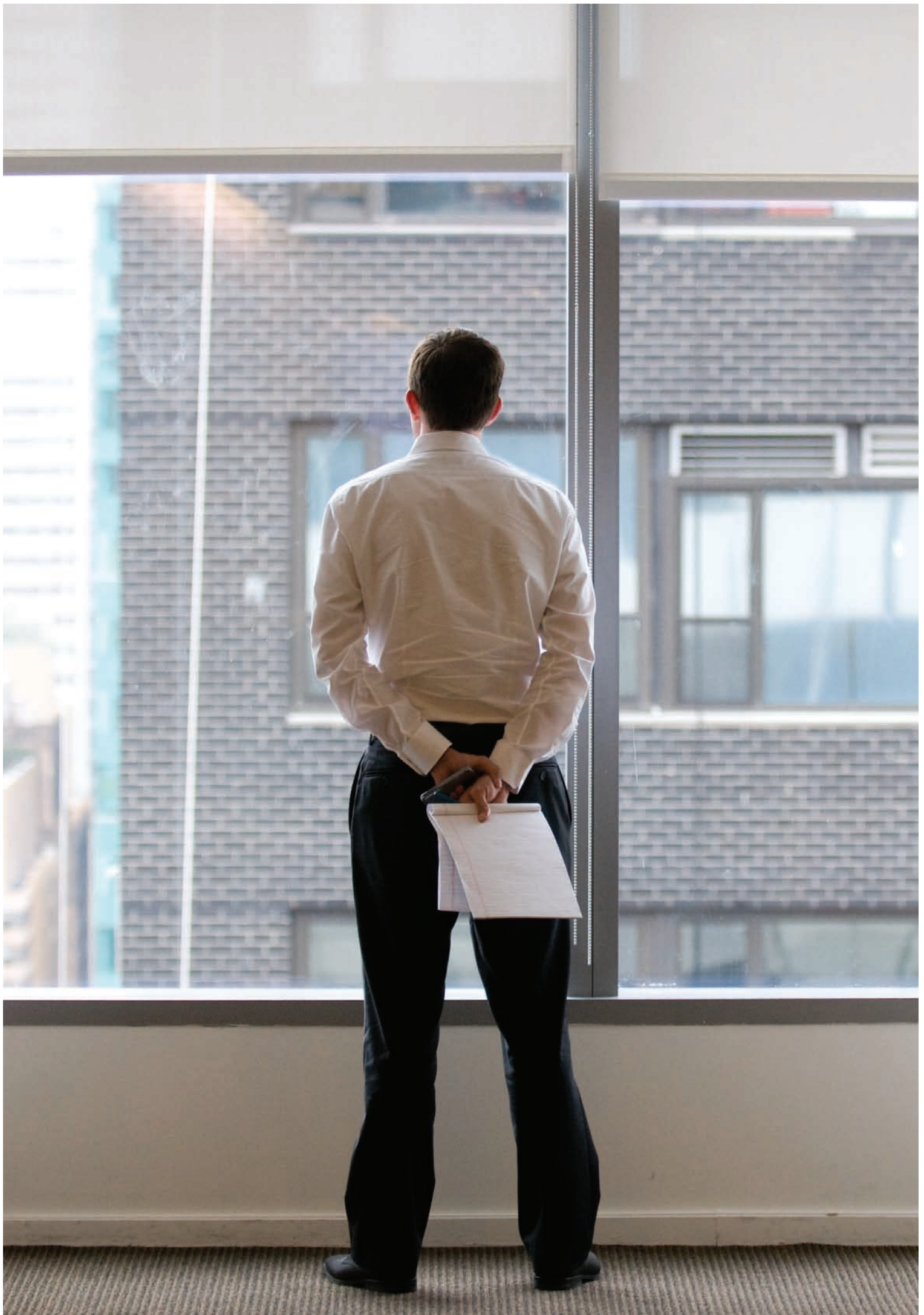
The disclosures in the financial statements include the operating lease commitments for minimum lease payments. The operating lease commitments are generally disclosed in a first year lease commitment, lease commitment for the years 2-5 and lease commitment after 5 years. On the basis of these disclosures in the financial statements and certain assumptions, an allocation of lease payments was performed to individual years. These annual lease payments were subsequently discounted. The discount rate applied was a company's incremental borrowing rate taking into account a company's credit rating. If a credit rating was not available, the discount rate used was the industry average.

The increase in interest bearing debt is determined using the calculated lease liabilities for off balance operating leases and their relative impact on interest bearing debt.

Leverage was defined as interest bearing debt divided by equity. The calculated increase in lease liabilities was used to determine the increase in leverage presented in percentage points.

The increase in EBITDA was determined by adding back the disclosed rent expenses. In instances where these were not disclosed separately, the annual rent expense is approximated with reference to the disclosed first year operating lease commitments.





# Contacts

For more information go to [www.pwc.com](http://www.pwc.com) or contact a member of our lease team:

**Jay Tahtah**

Accounting and Valuation Advisory Services

E-mail: [jay.tahtah@nl.pwc.com](mailto:jay.tahtah@nl.pwc.com)

Tel: +31 (0)88 792 39 45

**Alexander Spek**

Accounting and Valuation Advisory Services

Email: [alexander.spek@nl.pwc.com](mailto:alexander.spek@nl.pwc.com)

Tel: +31 (0) 88 792 50 46

PwC has multi-disciplinary teams of specialists in each country who can provide you with more information and/or assist you in assessing the impact of the proposed lease accounting model on your business.

