



RETAIL/LEISURE AND HOSPITALITY

A NEW LEASE OF LIFE YOU COULD DO WITHOUT?

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INTRODUCTION

There is hardly a commercial enterprise anywhere that does not lease an asset of some description somewhere in its operations. For that reason, the International Accounting Standards Board's (IASB's) recently issued Exposure Draft (ED) on the accounting for leases could bring about the most wide ranging change that finance departments of companies reporting under International Financial Reporting Standards (IFRS) have had to deal with since the transition to IFRS itself.

A final standard reflecting the requirements in the ED would have the greatest impact on entities whose cost base comprises significant lease costs. Therefore companies in the leisure, hospitality and retail sectors will be particularly affected given that they usually lease their premises and often operate out of multiple sites.

Companies reporting under UK Generally Accepted Accounting Practice (UK GAAP) are not yet affected. However, with the future of UK GAAP currently in a state of flux, and given the UK Accounting Standards Board's preoccupation with aligning as far as practicable UK GAAP with IFRS, the principles embodied in the ED could ultimately be reflected in UK GAAP at some point.

HEADLINE ACCOUNTING IMPLICATION

The headline message is that the distinction between operating leases and finance leases, currently driven in IAS 17 *Leases* by an assessment of whether the risks and rewards of an asset have passed to the lessee, would disappear. The model under the proposed standard would result in the recognition of a "right of use" asset and corresponding liability for lease payments in the accounts of the lessee. In other words, leases currently classified as operating leases would have to be accounted for in the same way as finance leases, bringing an end to the availability of the most common form of off-balance sheet finance currently used by companies.

Looking at just the property leases of companies in the leisure, hospitality and retail sectors this would mean:

- Recognising a liability for the present value of total rentals due to the landlord over the lease term, and a corresponding non-current asset representing the right to use the property for the lease term.
- Higher reported EBITDA as operating lease expense in the income statement would be replaced by depreciation on the "right of use" property asset and an interest charge on the obligation to pay rentals over the lease term.
- Reduced interest cover and higher gearing ratios.
- Higher overall charges in the income statement in the earlier years of the lease and lower charges in the latter years as the finance charge will reduce over time as the lease obligation reduces. This contrasts with the straight-line charging of rental payments when classified as an operating lease under the current regime.

The graph opposite shows what the effect would be on the income statement of a 10 year operating lease with an annual rental of £100,000, with a 10 per cent discount rate. The aggregate charge over the 10 year period is £1m whether accounting under current IAS 17 or the ED, but the period by period charge is different.

Lease accounting compared



Of course, this isn't just an issue affecting property leases. The same principles would have to be applied to the accounting for all leases, from photocopiers and computers to aeroplanes. Indeed, the introduction of a standard reflecting the ED's requirements would see Sir David Tweedie, outgoing Chairman of the IASB, achieve his often stated lifetime ambition of flying in an aeroplane that appears on the balance sheet of the airline he is flying with!

SOME DEVILISH BITS TO THE DETAIL

As well as the headline issue of all lease liabilities coming on balance sheet, there are other aspects of the accounting contained in the ED that will raise a few eyebrows. Of particular note is perhaps the extensive amount of judgement that is required. Companies are therefore likely to find themselves entering into more discussions with their auditors on the appropriateness of the judgements made. Some of these aspects are discussed further below.

Break clauses

In determining the initial carrying amount of the lease liability and "right of use" asset it is necessary to make an assessment of the lease term on a lease by lease basis. For fixed length leases this is straightforward, but many leases, particularly property leases, have break clauses. The existence of one or more break clauses will force companies to make an assessment of the likelihood of such break clauses being exercised on inception of the lease. This clearly involves an element of judgement, with the shorter the estimated lease term, the smaller the lease liability recognised.

Furthermore, the probability of exercising a break clause would need to be re-assessed at each subsequent balance sheet date with adjustments being made to both the lease liability and the "right of use" asset if future expectations change.

Turnover rents

The current leasing standard, IAS 17, addresses the accounting for "contingent rents" which would encompass contractual features such as turnover rents. Under the current regime, such amounts give rise to an expense when they arise, even for leases accounted for as finance leases.

By contrast, under the accounting proposed in the ED, contingent rents would have to be estimated at the outset (again on a lease by lease basis) impacting the measurement of the "right of use" asset and lease obligation. Such measurement will be on an expected value basis, which for turnover rents would require a probability-weighted average applied to expected forecast turnover. Again, this highlights the extent to which judgement is instrumental in determining the measurement of the "right of use" asset and lease liability. As you might now guess, such estimates would need to be revised at each balance sheet date if, as is likely, forecast turnover is revised.

Lease incentives

The proposed standard is silent on the accounting for lease incentives. Indeed, the only time the word "incentive" is mentioned in the ED is to note that the current guidance in SIC 15 *Operating Leases – incentives* will be withdrawn!

For incentives such as rent free periods this does not cause any great difficulties, as it is just factored into the overall present value of lease payments. However, where a landlord agrees to, say, pay some or all of a property's fit-out costs it is less clear what the accounting should be.

Discount rate

The discount rate to apply to the future lease payments in measuring the lease obligation and "right of use" asset is the rate being charged by the lessor. If this cannot be reliably determined, as will often be the case, then the lessee's incremental cost of borrowing is used – essentially the interest rate that the company would incur to borrow, over a similar term, the funds necessary to buy the underlying asset. This will be a combination of LIBOR rates and a premium for the credit rating of the company concerned. Unless a company has borrowed money at or around the same time as entering the lease, judgement will again be required to estimate the discount rate.

It also means that two companies with an identical lease could end up with different accounting if one has a higher cost of borrowing than the other. Although the aggregate income statement expense over the term of the lease will be the same, the company with a higher cost of borrowing will reflect a lower depreciation expense (because the initial measurement of the "right of use" asset will be lower), offset by higher finance charges (because the interest rate applied to the lease obligation is higher).

The discount rate is determined on inception of the lease and is generally not revised thereafter, even if the company's incremental cost of borrowing changes.

Deferred tax

Where IFRS is only applied in consolidated financial statements, with UK GAAP applied at the individual company group level, there could be deferred tax implications to consider. This is because the profit and loss account charge recognised by individual group companies on a UK GAAP basis (operating lease expense) and on which tax deductions are received will not be the same as the consolidated IFRS income statement charge (depreciation and interest charges).

Presentation

The language used in the ED is somewhat confusing as at one and the same time it requires the "right of use" asset to be presented both within, and separately from, other items of PPE on the face of the balance sheet. It is possibly an unnecessary level of detail to be shown separately on the face of the balance sheet. Disclosure in the notes would seem to be sufficient, as is currently the case under both UK GAAP and IFRS for leases classified as finance leases.

Interestingly (or even bizarrely) although the "right of use" asset is presented on the face of the balance sheet as PPE, the ED requires that amortisation of the "right of use" asset is determined in accordance with IAS 38 *Intangible Assets*. However, whether depreciated in accordance with IAS 16 *Property, Plant and Equipment* or amortised as an intangible asset in accordance with IAS 38, it is unlikely there would be a difference in the amount charged each period.

The lease obligation would be split into current and non-current amounts based on the lease payments to be made within 12 months of the balance sheet date and lease payments to be made thereafter.

Sub-lets

The accounting is likely to prove equally challenging for companies that sublet property. If a company sub-lets then it will be important to consider the lessor sections of the ED.

COMMERCIAL CONSIDERATIONS

Of course, there are wider issues to consider than just the compliance aspect of computing the various adjustments necessary to be able to apply the final standard if and when it comes in. Other issues that companies will have to deal with might include consideration of the impact on:

- Debt covenants, particularly given the negative impact the standard will have on interest cover (due to the introduction of interest charges) and gearing ratios (due to all lease obligations coming on balance sheet).
- Tax planning structures that are dependent on achieving operating lease classification under the current regime. As tax is assessed on the profits of individual companies, this would be of greater immediate concern to those that apply IFRS in individual financial statements than those who only apply IFRS in their consolidated financial statements.
- Profit-related payments to employees and others such as contingent consideration in business combinations, given that the pattern of expense recognition would be different.
- The amount of distributable profits given that there is likely to be a difference between the amount recognised for the "right of use" asset and the obligation to pay rentals. Again, this will only be an issue for UK companies if they have adopted IFRS in individual company accounts.

TIMETABLE

The comment period for the proposals ends on 15 December 2010, with a final standard planned for issue in the second quarter of 2011. The effective date of the new standard will depend largely on meeting this date for publication, which in turn is likely to be driven by the comments received on the ED. Some commentators have suggested that the earliest mandatory date of adoption would be accounting periods beginning on or after 1 January 2013.

FINAL THOUGHTS

We have tried to keep the above overview brief and simple. As ever with IFRS and new accounting pronouncements, the devil can be in the detail of both the proposed standard and its implementation. If you want to discuss the implications of this proposed standard on your business in more detail or would like assistance in either assessing and quantifying its impact or developing a robust process for ensuring compliance, please contact your usual BDO contact, who will be pleased to help.

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