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Moore Stephens Property Flash

Leases Update - Impact on Real Estate

Changes in lease accounting requirements that will significantly impact the global financial reporting landscape are likely to be published within the year, according to a Project Update published by the International Accounting Standards Board (IASB) in March 2015.

These requirements are likely to result in many off-balance sheet lease financing arrangements being brought onto the books. No specific exemptions will be granted to the real estate industry.

The new proposals mainly impact lessees, while leaving the accounting for lessors relatively unchanged. Key changes relating to lessees are summarized below.

- Most property leases will be reflected as financing arrangements on the balance sheet

  Lessees will have to account for most property leases on the balance sheet as a lease asset and a corresponding liability. The off-balance sheet financing benefits resulting from the operating lease model of today will largely be no longer available, with a possible consequent impact on balance sheet gearing and debt covenants. Exemptions are being granted for short-term leases (under twelve months) and leases of "small" assets , which are not considered further in the rest of this article.

- Front-loaded expenses in the income statement

  The lease proposals require lessees to account for leases based on a model similar to the finance lease model of IAS 17, which front-loads the interest expense on the lease liability. Lessees that qualified for the operating lease model under IAS 17 will be impacted by a forward shift in the expense recognition pattern.

- Increased financing cash outflows in the cash flow statement

  The new model will require lessees to regard a portion of lease payments as being principal repayment of the lease liability and be classified as financing cash outflows, similar to the finance lease model under IAS 17. Property leases that were previously accounted for as operating leases under IAS 17 will see greater financing cash outflows under the new model, offset by a compensating change in operating cash flows.

[1] IASB may include a quantitative threshold of what qualifies as "small" in the basis of conclusions when the final standard is issued.

- Lessees accounting for investment properties at fair value must record leased properties similarly

Under existing rules, IAS 40 provides a policy choice for investment properties that are acquired under operating leases. Specifically, if the lessee adopts a fair value model for investment properties, the lessee can choose to account for the property at fair value, or regard the lease as an off-balance sheet arrangement.

The lease proposals eliminate this choice and requires a lessee to account for these properties at fair value.

- Sales and leaseback transaction financing will no longer be off-balance sheet

The revised proposals require seller-lessees to recognize all leases on the balance sheet, which removes the ability of sale and leaseback transactions to provide off-balance sheet financing.

Further, such transactions may not qualify as a "sale" under the new revenue recognition rules in IFRS 15, which require control of the property to pass to the buyer for such "sale" to have occurred. IASB has decided that a sale and purchase transaction that is accompanied by a substantive seller's option to repurchase the property should be accounted for as an outright financing arrangement as it is deemed that no "sale" has occurred.

For sale and leaseback transactions that qualify as a "sale", any gain on disposal recognized by the seller-lessee will be reduced. The portion of the gain relating to the retained lease asset should be adjusted against the lease asset and amortized over the period of the lease.

Although IASB has yet to decide on the transition date, our view is that this date is unlikely to be before 1 January 2018 given the widespread impact of the changes. In Singapore, the Accounting Standards Council has not issued further updates on the adoption of the lease accounting changes, although in our view, it is likely that the changes, when issued globally, will be adopted in Singapore as well.