EXPOSURE DRAFT: ACCOUNTING FOR LEASES
(DECEMBER 1980)

Comments as forwarded by the N.S.W. Division of the Securities Institute of Australia to the Australian Accounting Research Foundation.

The Securities Institute of Australia has been asked by the Australian Accounting Research Foundation to comment on the proposed statement of accounting standards for “Accounting for Leases” (December 1980). The exposure draft provides procedures for reporting of lease transactions in Australia. The document does not cover lease agreements such as exploitation and exploration of natural resources and also assets such as motion pictures, plays, manuscripts etc. It also does not apply to leveraged leases by lessors.

Summary of Conclusions
It is generally thought that a certain amount of experience needs to be developed in accounting for leases. Whilst the amount of leasing currently being undertaken is substantial, it does only represent a small part of the borrowing facilities used by most companies, and in general terms has not required close attention by users. However, it is obvious that as new financial facilities are being introduced, there will be greater application of leasing as a funding source for resource developments. As a result, accounting for leases is going to attract more attention in credit assessment and it is appropriate that the accounting body initiates some move now to establish a standard. However, it is the recommendation of the Institute that the finer points of accounting standards be allowed to evolve from experience of both users and providers and that no formal method be implemented until comments on general experience are fed back to accounting bodies. It is therefore proposed that as a first stage more disclosure should be introduced in the accounts in the form of footnotes which cover such aspects as capital values relating to lease commitments and more details on lease obligations and for lessors, more details on the make-up of lease receivables. Capitalisation of leases should be introduced as Stage 2 of the implementation programme to allow time for Stage 1 to be firmly established on an effective basis.

Capitalisation
The Institute recognises the various arguments in favour of capitalisation, especially the reflection of the lessee’s economic resources (leased property) in the balance sheet and the subsequent level of obligations to be met under those leases. However, equally so it could be argued that the same amount of information could be conveyed to users of financial statements through an improved footnote disclosure. Moreover it should be noted that unless it is accompanied by appropriate footnote disclosure, capitalisation may in fact result in a loss of information to users of financial statements. We support the view held by the Australian Accounting Research Foundation that it would be premature to make capitalisation of finance leases mandatory, at least until preparers and users of financial statements have had more experience in presenting and interpreting information relating to leases on an expanded disclosure basis.

The disclosure requirements set out by the Australian Accounting Research Foundation may be overstated. Whilst it is generally agreed that there is a need for greater disclosure and any additional information is certainly to the benefit of users of financial statements, it is recognised that the preparation of such information is time consuming and that it should only be prepared and presented to financial users if it serves a specific purpose. The amount of information available on other areas of financial statements is also limited but an improvement in the area of leasing disclosure certainly creates a standard for the presentation of other financial data. The Institute would therefore support any move to add more information to financial statements to permit a meaningful assessment of the financial status of a lessee or lessor. However, the Institute recognises that it may not be essential for details of minimum lease payments for each of the five succeeding financial years to be disclosed but that a grouping, similar to that adopted by finance companies describing maturity patterns (that is, 0-2 years, 2-5 years and 5 years and over categories) be provided. The Institute also recognises arguments that such disclosure could be misleading but nevertheless it does go part of the way to providing more information to investors. It is generally accepted that a much more important aspect in credit assessment is cash flow statements and projections and one should not rely alone on balance sheets. Nevertheless a balance sheet does represent a readily available document for assessment purposes.

Many of the elements of capitalising leases are subjective and this in itself is justification for full disclosure of lease commitments as an expense, rather than capitalisation,
or at least a combination of both. It is essential that a financial analyst understands the impact on cash flow and appreciates the intrinsic value of the lease to the earning capacity of the company. This suggests that a detailed explanation of commitments and intrinsic asset values would be of more value than capitalisation. Each company is assessed on its merits and if leasing forms a major part of the company’s assets, calculated rates of return on funds employed would need to reflect this. To a large extent the usefulness of capitalisation or expense accounting depends upon the elements used in assessing particular companies: e.g. interest cover, gearing, return on assets etc.

Also, Trust Deed borrowing limitations would need revision in view of the impact capitalisation would have on gearing ratios. For example, the Deed could fix a level of future lease commitments, and/or define conditions for capitalisation. The subjective nature of the latter may cause problems in interpretation of Trust Deeds.

The finer points of accounting for leases will evolve from experience, and corporate secretaries will probably need to be “sold” the alternative accounting methods. In view of this, it is suggested that capitalisation be phased in over a period of say 5 years and that from that date the accounting bodies take a firm view by making it mandatory for all lessees to capitalise leases and provide appropriate footnotes to support the capitalisation. Such footnotes would include the separation of leased assets from other assets and similarly for the recorded liability. Also, the interest component relating to leased assets should be distinguished from the interest component derived from debt financing. The purpose of separating these two financing sources, and their costs, is purely an endeavour to refine the analysis of financial statements so that the user can differentiate between the different financing sources the company is using.

Leasing for Land and Buildings
Under this section two problems arise: the definition of “relatively insignificant”; and the basis of allocation of minimum lease payments as between land and buildings. Normally in the case of a lease of land the rental payments will consist essentially of a return on the lessor’s investment in the nature of interest. In the case of the lease of buildings or depreciable assets, however, the rental payments would normally comprise of two elements:-

i) a return on the lessor’s investment in the nature of interest; and

ii) a recovery of part of the lessor’s capital investment to compensate the lessor for the depreciation of the leased asset.

Apportioning the rental payments purely on the basis of fair values of the land and buildings at the date of inception of the lease will result in over-allocating the amount attributable to the land and under-allocating the amount attributable to buildings.

Contingent Rentals
It is thought that the statements on Contingent Rentals are not clear. It is apparent from the disclosure draft that where lease payments relating to the future use of the leased property are of an uncertain nature they should be excluded from any minimum lease payments and accounted for only during the period in which they occur. However, it appears that if the lease payments are based on known and measurable factors such as the CPI, or a margin above a certain interest rate, contingent rentals should be built in to the minimum lease payments. Subsequently, any variations from future estimates and actual rental payments would be treated as contingent rentals. The Institute suggests that the statement on contingent rentals be given closer attention to identify more clearly how minimum lease payments are used especially in present value calculations for those cases where rentals are based on some measurable factor such as the CPI or a margin above a certain interest rate.

Accounting for Leases by Lessor
Whereas the exposure draft was expansive on the matter of disclosure in the accounts of lessees, it contained no recommendations at all in regard to the accounts of lessors. The committee identified a number of areas of information which a user of financial statements would need to adequately review the value of a lessor’s lease receivables.

There is the need for the accounting bodies to issue a standard on accounting for unearned income because of the disparity of results given by the range of alternative methods for apportioning unearned income over the term of the lease. There is also an absence of accounting standard on disclosure of sales type or direct financing lease receivables.

Specific disclosure requirements should include: analysis of type of equipment; break-up of instalment and residual receivables; and type of lease.

General Comments
The scope of the draft was restrictive in that the exposure draft on “Accounting for Leveraged Leases by Lessor” (January 1981) is already dealt with in Parts 1 and 2 of this exposure draft and this has resulted in a great deal of duplication. It is believed that it would be more logical and convenient if the two exposure drafts were combined into a single statement of accounting standards – “Accounting for Leases”.

JASSA/1981, No. 2 (July)
There are a number of instances in the exposure draft where definitions need to be restated to reduce inconsistencies and ambiguities. It is felt that a distinction should be drawn between minimum lease payments and any guaranteed residual value, so that the amount the lessee would be required to pay in due course could be identified separately from the amount that he could be liable to pay if the actual residual value of the property was less than the guaranteed value. In respect of definitions relating to finance and operating leases, it is felt that there were some inconsistencies between these definitions in that the lease transfers from the lessor to the lessee substantially all the risk incident to ownership. However, it does not necessarily follow that the lease transfers substantially or even a major part of the benefits of ownership.

MEETING OF THE ASIAN SECURITIES ANALYSTS COUNCIL

Members are advised of a meeting of the Asian Securities Analysts Council in Seoul, Korea, October 18-27, 1981.

Preliminary Programme

October 18, Sunday : Arrival at Seoul, welcome Reception
October 19, Monday : ASAC Meeting
October 20, Tuesday : Morning: Visit to the Korea Stock Exchange
                      ICC Meeting
                      Afternoon: Seminar
October 21, Wednesday : Morning: Visit to Korean Companies
                      Afternoon: Move to Tokyo
October 22, Thursday : Tokyo Meeting including Company visits
October 23, Friday :
October 24, Saturday : Sightseeing. Move to Hong Kong
October 25, Sunday :
October 26, Monday : Hong Kong Meeting
October 27, Tuesday :

If any members of the Institute will be in Seoul at that time and plan to attend the meeting, could they please contact the Federal Secretary.