BrexIFRS

The story goes that when Sir David Tweedie was chairman of the International Accounting Standards Board (IASB), he joked that his lifelong ambition was to fly in an aircraft that actually existed on the airline's balance sheet.

Lease contracts are not straightforward. There has long been debate amongst the accounting standard setters about how to classify and account for them.

According to International Financial Reporting Standards (IFRS), as applicable in the EU and UK, a lease is a contract which "conveys the right to control the use of an identified asset for a period of time in exchange for consideration". According to the US Financial Accounting Standards Board (FASB), leasing refers to the "*means of gaining access to assets, of obtaining financing, and/or of reducing an entity's exposure to the full risks of asset ownership*". The wording may differ, but the substance is essentially the same.

Prior to 2019, the similarities did not end there. Although each standard had different sets of rules, they both classified leases into one of two camps, namely "finance" or "operating" leases, with very similar accounting treatment across regions and governing bodies in each instance.

Finance leases are typically associated with (deemed) ownership over the longer term. A good example is your home mortgage. A typical buyer would not have enough funds available to purchase a house without a mortgage, so they might make a partial equity down payment and finance the remainder with a mortgage loan. From an accounting perspective, the associated asset, liability and equity exist on your personal balance sheet. Certainly, if you sought to purchase a second home, that lender would want you to disclose all your existing assets and liabilities, in addition to your income and expenses. The higher your "leverage" (i.e., the more debt you have relative to assets or income), the riskier the prospective loan, and the higher the interest rate the lender will charge as a consequence.

Operating leases, on the other hand, are associated only with a "right of use" and typically have shorter tenures. For example, if you rented a home on a one-year contract, there is no ownership, no asset, and no long-term liability associated with it.

Often the difference between the two is a grey area, exploited by unscrupulous financial engineers trying to earn their keep by keeping leases off the balance sheet in order to hide leverage. For example, what if you signed a 25-year "operating lease", with an option to buy at expiry? Would you be able to keep that off your balance sheet? In reality, how different is that to a 25-year interest-only mortgage - which would be classified as a finance lease? Certainly, if there was a 3-months' notice cancellation clause, that would make it an operating lease. Prior to 2019, the standard setters used substance over form principles, i.e. guidance which allowed some leeway in classifying leases into either camp. These were nonetheless exploited, explaining the impetus of Sir David and his cohorts to clamp down and fix lease accounting once and for all.

The IASB is part of the alphabet soup that sets IFRS Standards, the gold standard for companies wanting to access funding from global capital markets: "*The IFRS Foundation is a not-for-profit, public interest organisation established to develop a single set of high-quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards — IFRS Standards — and to promote and facilitate adoption of the standards"* …the key word being *"single*".

Prior to the establishment of the IASB in 2001, there were disparate national accounting standards, which proved challenging for global investors and multinational CFOs alike. Its predecessor, the International Accounting Standards Committee (IASC) was established in 1973 and published International Accounting Standards (IAS), which formed the basis upon which many national accounting standard setters had developed their domestic GAAP (Generally Accepted Accounting Practice) standards. In 2001, the IASB replaced the IASC, with a remit to bring about convergence between domestic GAAP standards through the development of global IFRS accounting standards. Essentially, IAS "directives" became IFRS rules. In 2002 the European Union agreed to adopt IFRS standards for multinational companies maintaining listings or raising capital within the EU, which was a catalyst for their adoption globally. Foreign companies seeking listing in the US still need to adopt US GAAP, on the other hand.

What should have followed if stakeholders (global investors, CFOs and the like) were to have their way, would have been further convergence of IFRS and US GAAP into a single global standard. Instead, what seems to be happening now is a divergence, a cold war competition for global dominance between the two standards, in direct contradiction to the IFRS mission statement.

Nowhere has this chasm been more evident to those of us who actually use and try to rely on these financial statements, than in the adoption of IFRS16 and ACS842 (FASB) respectively to deal with off-balance sheet operating leases.

Without getting too deep into the detail, FASB paid heed to Sir David's lifelong ambition, requiring the recording of operating leases onto the balance sheet as separate line items – a right of use asset and corresponding lease liability. Notably, FASB did not require material changes to the income nor the cashflow statement. In so doing, they sought to provide more disclosure as to (potential) leverage but without decreasing the comparability of financial statements for investors, nor obscuring economic reality.

By way of example, under ACS842 (FASB), if you rented a shop for 10 years, you would have to record the net present value (NPV) of that right of use asset as well as the corresponding liability on your balance sheet. Nothing changes in the income statement or the cashflow, however, with the annual rental payments booked as an expense. No real harm has been done: investors are free to simply ignore the new line item from their debt calculations, whilst still being able to analyse historical financial metrics (profit margins, free cash flow, leverage etc.) on an apples-to-apples basis. ▶▶

IFRS on the other hand went much further - to the detriment of stakeholders in our opinion. IFRS16 completely did away with the distinction between operating and finance leases. Effectively, everything is accounted for like a finance lease today. Not only must all operating leases be recorded on the balance sheet (as with FASB), but the NPV of the aforementioned 10-years' worth of rent would be deemed capital expenditure upfront in the cash flow statement and depreciated over the term as if you were the property buyer (which you are not). Moreover, under IFRS16, accountants should not expense the actual rental payments in the income statement; rather they must use an amortisation table, assume an interest rate on a fictitious mortgage (the right of use liability) and expense only the inferred interest through the income statement, the remaining capital portion being reserved to service the mortgage you do not actually have (through the cash flow statement).

Why does this matter you may ask? As global investors, we need to be able to compare companies on a consistent basis, both historically and relative to peers. Essentially IFRS16 has, at the stroke of a pen, rendered historical and cross border analysis of various income and cash flow statement metrics useless - without wholesale, time consuming adjustments and subject to errors from our data providers.

Our sense as a stakeholder, is that after being centralised for over 20 years, the IASB has forgotten its mission principles and become aloof from its stakeholders. Evidently, they seem to be competing with FASB to become the dominant standard, rather than co-operating to create a uniform one. FASB on the other hand being based in the US is more accountable (pun intended) to their local stakeholders. Never mind Brexit, if IFRS16 is anything to go by the UK should adopt FASB and BrexIFRS! ■

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