J. of Acc. Ed. 33 (2015) 228–240

Contents lists available at ScienceDirect

J. of Acc. Ed.

journal homepage: www.elsevier.com/locate/jaccedu

Educational Case

The warehouse capital management policy – Treatment of leases ☆

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ARTICLE INFO

Article history:
Available online 27 May 2015

Keywords:
Lease accounting
Constructive lease capitalisation
International Financial Reporting Standards
Debt agreements
Financial ratios
Accounting case study
Teaching resources

ABSTRACT

This case requires the use of financial statement footnote data to constructively capitalise operating leases. This is important because the joint FASB/IASB project has a proposal to capitalise most leases that are currently off-balance sheet. The impact of lease capitalisation is assessed by calculating common financial statement ratios and comparing the results to a lease multiple. Multiples are a rule-of-thumb method of estimating lease capitalisation. But are they accurate? The economic consequences of lease capitalisation are investigated. First, the impact on the firm's capital management policy is assessed. This includes the impact on accounting ratios that are required to be maintained by the firm's debt contract. Second, the impact touches on a potential 'sale and leaseback' business decision.

1. Background

1.1. The warehouse

The Warehouse is one of New Zealand's largest retailers, known for its wide range of products from clothing, entertainment, technology, music, sporting, gardening, and grocery. In 2012 it operated 92 stores throughout New Zealand. It is New Zealand owned and listed on the NZX.

Despite tough trading conditions following the 2007 and 2008 financial crisis, the company continued its strong cash flow performance. It was able to fund future capital requirements from existing facilities and to retain the current dividend payout ratio of 90% of adjusted net profit after tax.

Although a significant increase in capital expenditure is planned, the board's objective is to continue managing capital structure with the intention of maintaining conservative gearing ratios in line

☆ This paper was processed and accepted by the previous editor, David E. Stout.
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http://dx.doi.org/10.1016/j.jaccedu.2015.04.004
0748-5751/

with its existing policies. Cash generated from any possible sale of property assets would be applied to debt reduction in the first instance.

The Warehouse follows International Financial Reporting Standards (IFRS). The statement of accounting policy states:

> *These financial statements have been prepared in accordance with New Zealand Generally Accepted Accounting Practice and New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS). The financial statements also comply with International Financial Reporting Standards (IFRS).*

1.2. Lease accounting

IAS 17 begins with the premise that there are two types of leases: operating and financing. Operating leases are viewed as the temporary use of someone else's property and only the lease rental payments are recognised in the financial statements. The leased asset and any commitment to make lease payments are off-balance sheet. Finance leases are accounted for as an asset acquisition with specific debt financing.

Unfortunately IAS 17 is a rules-based standard that contains detailed requirements to decide whether a lease is operating (off-balance sheet) or finance (on-balance sheet). There is a concern that many leases are structured so that they meet the conditions for operating lease accounting and therefore remain off-balance sheet.

Academics, regulators and practitioners have long argued over whether lease contracts result in assets and liabilities that should be recognised in the financial statements. In the meantime, academics and financial analysts have developed techniques for 'capitalising' operating leases. These techniques range from the rule-of-thumb multiples to the discounting of future lease commitments.

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) are near completing a joint project on Leases (see Exhibit 1). ED/2013/6 *Leases* was published on May 2013 and the finalised IFRS is expected during the second half of 2015. The boards have agreed that lessees would need to reflect all leases (other than those eligible for exemption) as a right-of-use asset (reflecting the control conveyed over the asset acquired during the lease term) and a liability (reflecting the obligation to pay rent) on the balance sheet. However, the boards have not achieved complete agreement and they disagree on the reporting of the income statement impact.

2. Assignment questions

In view of the IASB'S project on leasing (see Exhibit 1), the Chair of the audit committee has asked you to review the impact of lease capitalisation on the firm's capital management policy.

For the purpose of this case, assume that it is September 6, 2012 and the annual report of The Warehouse Group has just been signed. Exhibit 2 presents the 2012 Income Statements, Statements of Comprehensive Income, Balance Sheets and Statements of Cash Flows.

The *capital management* policy from Note 3 is provided in Exhibit 3. Exhibit 4 provides financial statement Notes 8, 11 and 29, which support Note 3.

The audit committee would like to you to assess the impact of capitalising operating leases on the gearing (or leverage) ratios in the capital management policy statement. In your assessment you should complete the following tasks:

1. Capitalise the operating lease by discounting future lease rentals. Exhibit 5, Note 37 provides details of operating lease commitments. Be sure to document the assumptions you make.
2. The IASB has a project on accounting for leases. Exhibit 1 provides background and project milestones. The IASB is currently considering capitalising all operating leases. To illustrate the general impact of this proposal show the effect of lease capitalisation on the following ratios:
   - Current ratio,
   - Return on equity,
   - Return on assets,