IAS 17 - Leases

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Concept

- Lease is a popular financing option for acquisition of business property .
- It is a contract calling for the lessee (user) to pay the lessor (owner) for use of an asset.
- Lease Offers great flexibility and Economic advantages over ownership

History

- Lease was commenced in US as a new way to acquire equipment.
- It was in 1952 that the first leasing company was established in US.
- Before the advent of lease, corporations had devoted their own fund or borrowed capital to necessary equipment
- They noticed that the genuine purpose of equipment was not to purchase it but to utilize it, which led to the new system, lease.

Accounting

- Accounting is complex as it involves number of complexities mostly from alternative structures available
- Some are framed for tax benefits
- Others have lease term and implied interest adjusted to achieve economic objectives
- Lease can be used to transfer ownership of leased asset or risks associated
- Accounting requires application of principle of substance over form

RELATED INTERPRETATIONS

- IFRIC 4 Determining whether an arrangement contains a lease
- IFRIC 12 Service Concession Arrangements
- SIC 15 Operating Leases - Incentives
- SIC 27 Evaluating the Substance of Transactions in the Legal Form of a Lease

Objective of IAS 17

- The objective of IAS 17 is to
  - prescribe,
  - for lessees and lessors,
  - the appropriate accounting policies and
  - disclosures
  - to apply
  - in relation to finance and operating leases.

Scope

IAS 17 applies to all leases other than

- lease agreements for minerals, oil, natural gas, and
- similar regenerative resources and
- licensing agreements for films, videos, plays, manuscripts, patents, copyrights, and similar items. [IAS 17.2]

Scope

- However, IAS 17 does not apply for the following leases: [IAS 17.2]
  - property held by lessees that is accounted for as investment property for which the lessee uses the fair value model set out in IAS 40
  - investment property provided by lessors under operating leases (IAS 40)
  - biological assets held by lessees under finance leases (IAS 41)
  - biological assets provided by lessors under operating leases (IAS 41)

Classification of Leases

- Finance Lease
- Operating leases

The classification is based on the extent to which risks and rewards of ownership of the leased asset are transferred to the lessee or remain with the lessor.

Risks: Risks include technological obsolescence, loss from idle capacity, and variations in return.

Rewards: Rewards include rights to sell the asset and gain from its capital value.

Classification of Leases

- A lease is classified as a finance lease
  – if it transfers substantially all the risks and rewards incident to ownership.
- All other leases are classified as operating leases.
- Classification is made at the inception of the lease. [IAS 17.4]

Classifications of leases are to be made at *the inception of the lease.*

Inception of lease is before the agreement date and date of commitment by parties to the principal provision of the lease.

If the lease terms are subsequently altered to such a degree that the lease would have had a different classification at it inception, a new lease is deemed to have been entered into.

Changes in estimates such as the residual value of an asset are not deemed to be a change in classification.

Classification

A lease is classified as a finance lease if it transfers substantially all the risks and rewards of ownership to the lessee.

If it does not, then it is an operating lease.

Determining type of lease

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form. Situations that would normally lead to a lease being classified as a finance lease include the following: [IAS 17.10]
  - the lease transfers ownership to the lessee by the end of the lease term
  - the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised
  - the lease term is for the major part of the economic life of the asset, even if title is not transferred
  - at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
  - the lease assets are of a specialised nature such that only the lessee can use them without major modifications being made

Other indicators [IAS 17.11]

- if the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
- gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, by means of a rebate of lease payments)
- the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent .
- All the above eight criteria would be required to decide the classification . The first 5 criteria are determinative and the last three are suggestive.

LEASES OF LAND

If title is not transferred, are classified as operating leases, as land has an indefinite economic life and a significant reward of land ownership is its outright ownership and title to its realizable value.

If the title to the land is not expected to pass to the lessee, then the risks and

rewards of ownership have not substantially passed, and an operating lease is created for the land.

Leases of land and buildings need to be treated separately, as often the land lease is an operating

lease and the building lease, a finance lease.

- If the lessee is to classify the land and buildings as investment property under IAS 40 and the fair value model is adopted (the required model for operating leases under IAS 40), then separate measurement is *not required*.

- *Under IAS 40, property held by a lessee under an operating lease can* be classified as investment property and accounted for *as if it were a finance lease . Para IAS 40.6*

Accounting by Lessees

- At the commencement of the lease term, a lessee shall recognize an asset and a liability at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments. The appropriate discount rate in the present value calculation is the rate implicit in the finance lease—that rate which discounts the lease payments to the fair value of the asset plus any initial direct costs of the lessor

- The impact of this treatment is to reflect the economic substance of the transaction. The lessee has acquired an asset for the substantial part of its useful life and expects to obtain substantially all the benefits from its use. In other words, the lease arrangement is merely a financing vehicle for the acquisition of an asset.

Accounting by Lessees

- Subsequent to initial recognition, the lease payments are apportioned between the repayment of the outstanding liability and the finance charge so as to reflect a constant periodic rate of interest on the liability. Methods of calculation vary and include sum of the digits, which is a rough approximation, and more complex amortization models.
- The asset needs to be depreciated over its expected *useful life under IAS 16, using rates for* similar assets. However, if there is no reasonable certainty that ownership will transfer to the lessee, then the shorter of the lease term and the useful life should be used.

Accounting by Lessors

- **Finance Leases**
- Lessors shall recognize assets held under finance leases as a receivable equal to the net investment in the lease. The net investment in the lease is the aggregate of the minimum lease payments and any unguaranteed residual value (the "gross investment") discounted at the rate implicit in the lease.
- Due to the definition of the interest rate implicit in the lease—that rate which discounts the lease payments to the fair value of the asset plus the initial direct costs of the lessor—the initial direct costs of the lessor are automatically included in the receivable. The direct costs of the lessor are those costs directly attributable to negotiating and arranging a lease.

Accounting by Lessors

- Subsequent to initial recognition, finance income is recognized based on a pattern reflecting a constant rate of return on the net investment in the lease. Receipts under the finance lease are apportioned to the gross investment, as a reduction in the debtor, and to the finance income element.
- Lessors who are manufacturers or dealers should recognize profit on the transaction in the same way as for normal sales of the entity. Thus a finance lease will create a profit or loss from the sale of the asset at normal selling prices and a finance income over the lease term. If artificially low rates of interest are quoted, profit is calculated using market interest rates.

Disclosures for Finance Leases

The following disclosures for finance leases are required in addition to those required by the financial instruments standards

For each class of asset, the net carrying value at the balance sheet date

A reconciliation between the total of the minimum lease payments and their present value

The total of the future minimum lease payments analyzed as to

- Not later than one year;
- Later than one year but not later than five years; and
- Later than five years

Contingent rents

Total future minimum lease payments expected to be received under non cancellable subleases

A general description of the lessee's material leasing arrangements

Disclosures for Finance Leases
In addition to the requirements of the financial instruments standards, these disclosures are required

1. A reconciliation between the gross carrying amount of the investment in the lease and the present value of the future minimum lease payments receivable

2. The gross investment in the lease and the future minimum lease payments for each of the following:
- Not later than one year
- Later than one year but not later than five years
- Later than five years

3. Unearned finance income

4. Unguaranteed residual value

5. Doubtful recoverable lease payments

6. Contingent rents recognized as income

7. A general description of the significant leasing arrangements

Operating Leases

Lease payments under operating leases shall be recognized as an expense on a straight-line basis over the lease term unless another basis is more representative of the pattern of the user's benefit, even if the payments follow a different pattern

Do recognize the impact of incentives in operating leases. Often incentives to enter into operating leases take the form of up-front payments, rent-free periods, and the like. These need to be appropriately recognized over the lease term from its commencement. Thus, a rent-free period does not mean that the lessee avoids a rent charge in its income statement. It has to apportion the rent for the entire lease over the entire period, resulting in a reduced annual charge

Disclosures for Operating Leases

Total future minimum lease payments under non cancellable operating leases for each of the following

- Not later than one year;
- Later than one year and not later than five years; and
- Later than five years

Total future minimum lease payments expected to be received under non cancellable subleases

Lease and sublease payments and contingent rents recognized as an expense

A general description of the significant leasing arrangements

Disclosures for Operating Leases

In addition to the requirements of the financial instruments standards, a these disclosures are required

1.The future minimum lease payments under noncancelable operating leases for each of the

following:

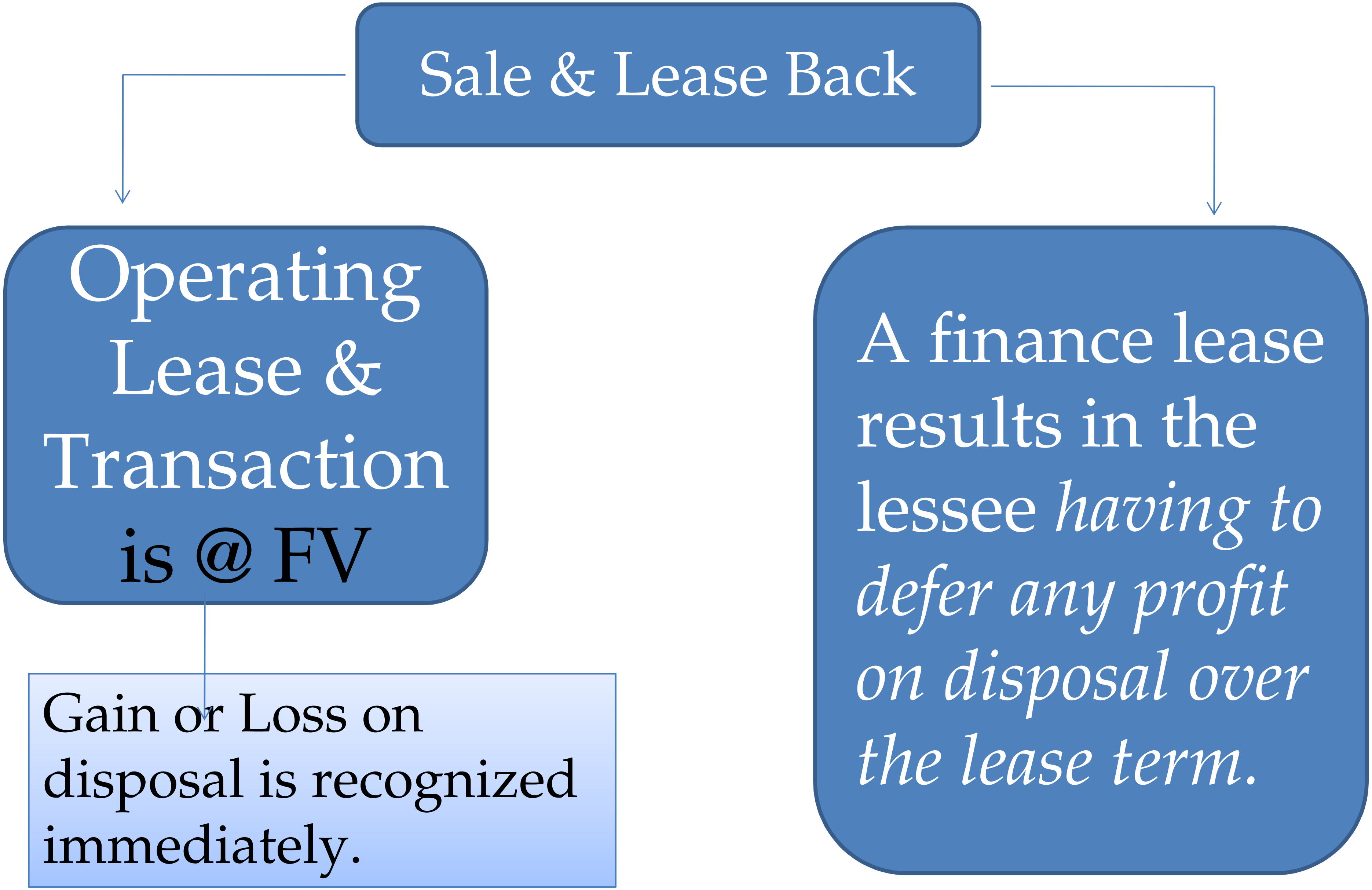
- Not later than one year
- Later than one year but not later than five years
- Later than five years

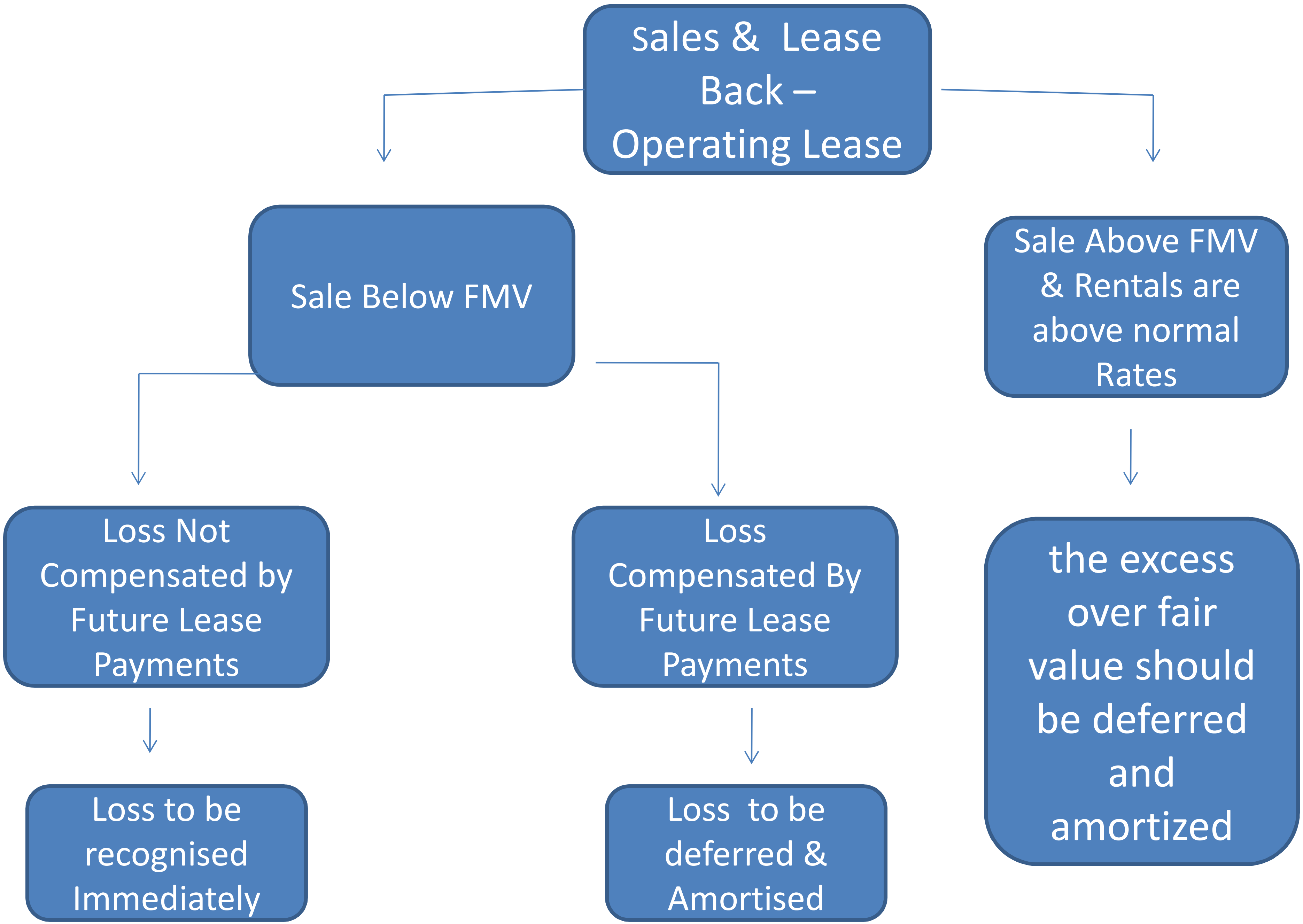
2. Contingent rents recognized as income

3. A general description of the significant leasing arrangements

Sale and Leaseback Transactions

- For a sale and leaseback transaction that results in a finance lease, any excess of proceeds over the carrying amount is deferred and amortised over the lease term. [IAS 17.59]
- For a transaction that results in an operating lease: [IAS 17.61]
- if the transaction is clearly carried out at fair value - the profit or loss should be recognised immediately
- if the sale price is below fair value - profit or loss should be recognised immediately, except if a loss is compensated for by future rentals at below market price, the loss it should be amortised over the period of use
- if the sale price is above fair value - the excess over fair value should be deferred and amortised over the period of use
- if the fair value at the time of the transaction is less than the carrying amount - a loss equal to the difference should be recognised immediately [IAS 17.63]


Sale & Lease Back
Operating Lease & Transaction is @ FV
Gain or Loss on disposal is recognized immediately.
A finance lease results in the lessee *having to defer any profit on disposal over the lease term.*


Sales & Lease Back – Operating Lease
Sale Below FMV
Sale Above FMV & Rentals are above normal Rates
Loss Not Compensated by Future Lease Payments
Loss Compensated By Future Lease Payments
the excess over fair value should be deferred and amortized
Loss to be recognised Immediately
Loss to be deferred & Amortised

Case Study

- An entity sells a piece of plant to a 100% owned subsidiary and leases it back over a period of 4 years. The remaining useful life of the plant is 10 years. The selling price of the plant was 20% below its carrying and market value. The lease rentals were based on market rates. The entity has no right to buy the plant back.

- How this transaction should be dealt with in the entity's financial statements.

Solution

- The lease will almost certainly be an operating lease, as the lease period is not for the majority of the plant's life and the rentals are based on market rates. However, the selling price was below the carrying and market value, and this loss has not been compensated by future rentals. Therefore, the loss should be recognized immediately.

Solution Continued

- The transaction will be eliminated on consolidation, but the individual entity accounts will recognize it. Also, the entities are related parties; therefore, the substance of the transaction will have to be carefully scrutinized. Although the entity has no right to reacquire the asset, it can exercise the right through its control of the 100% subsidiary. This control may change the designation of the lease.

Case Study

- An entity leases a motor vehicle over a period of five years. The economic life of the vehicle is estimated at seven years. The entity has the right to buy the vehicle at the end of the lease term for 50% of its market value plus a nominal payment of 0.5% of the market value at that date. This nominal payment is to cover the selling costs of the vehicle.

- How should the lease be classified in the financial statements of the entity?

Solution

- The lease will be a finance lease as the entity is likely to buy the vehicle at the price stated because it will be sold at 50% of the market value of the vehicle plus a nominal charge.

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SIC 15

- SIC 15, *Operating Lease— Incentives*, clarifies the recognition of incentives related to operating leases **by both the lessee and lessor**. Lease incentives should be considered an integral part of the consideration for the use of the leased asset. IAS 17 requires an entity to treat incentives as a reduction of lease income or lease expense. Incentives should be recognized by both the lessor and the lessee over the lease term, using a single amortization method applied to the net consideration.

IFRIC 4

- **IFRIC 4,** ***Determining Whether an Arrangement Contains a Lease*** deals with agreements that do not take the legal form of a lease but which give rights to use assets in return for payment. Such agreements would include outsourcing arrangements and telecommunication contracts. If the agreement conveys a right to control the use of the underlying asset then it should be accounted for under IAS 17. **This is the case if any of the following conditions are met**:

  - The purchaser in the arrangement has the ability or right to operate the asset or direct others to operate the asset.

  - The purchaser has the ability or right to control physical access to the asset.

  - There is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output of the asset and the price that the purchaser will pay is neither fixed per unit of output nor equal to the current market price at the time of delivery.

- SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, states that the accounting for arrangements between an enterprise and an investor should reflect the substance of the arrangement. All aspects of the arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.

- When the overall economic effect cannot be understood without reference to the series of transactions as a whole, the series of transactions should be accounted for as one transaction.

ILLUSTRATION LEASES

- A distributor of chemicals enters into a tolling agreement with a chemical producer. The producer agrees to build a bespoke facility to manufacture chemicals exclusively for the distributor. The useful Life of the facility is estimated at ten years, which is the same period as the tolling agreement between the two parties. The facility is designed to meet only the distributors needs. The distributors must pay a fixed capacity charge per annum irrespective of whether it taken any of the facility production. It also pays a variable charge based on the actual production taken, which amounts to approximately 90% of the facility total variable costs.
- This arrangement contains a lease. The asset in the agreement is the facility and fulfillments of the agreement is dependent on that facility which is bespoke for the distributors requirements . The distributors obtained the right to use the factory as it is bespoke for it is needs and could not reasonably be used for another purposes. The price it will pay per unit is neither fixed nor equal to the market price at the time of delivery.

ILLUSTRATION LEASES

- An entity entered into a five-year finance lease on 1 January 2007. The fair value of the leased asset was CU11,500. Lease rentals of CU3,031 are payable annually in arrears on 31 December each year. The rate of interest implicit in the lease is 10%

- The asset is included in non- current assets at its fair value of CU11,500 and depreciated over the five year term

- The finance charge for the year to 31 December 2007 is calculated on the outstanding balance of CU11,500 The finance cost will be CU1,150.

- At 31 December 2007 at lease liability of CU9,616 is calculated as the initial amount of CU11,500 Plus the accrued interest of CU1,150 less the repayment of Cu3,304.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*

- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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