

Practical Workshop for NBU Staff

IAS 17: Leases

CFRR»»

Centre for Financial
Reporting Reform



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November 17, 2015



Why IAS 17 important for bankers?

- » Finance leases are accounted for in a similar manner to:
1. Credit transactions
 2. Cash transactions
 3. Sale and leaseback agreements
 4. Loan forgiveness



Accounting for leases

- » IAS 17 LEASES prescribes the accounting policies and disclosures applicable to lessors and lessees engaged in a lease contract.
- » A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or a series of payments the right to use an asset for an agreed period of time.
- » The standard is based on the fundamental distinction between finance leases and operating leases, leading to different recognition and measurement provisions both in balance-sheet and profit and loss.



The fundamental distinction

- » A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
- » An operating lease is a lease other than a finance lease.
- » To apply the standard:
 - » Q1: is there a lease?
 - » Q2: if so, is the lease a finance lease?



Scope

- » **IAS 17 applies to all leases, except** lease agreements for :
 - » Minerals, oil, natural gas and similar non-regenerative resources
 - » Licensing agreements for films, videos, plays manuscripts
 - » Patents, copyrights and similar items.
- » IAS17 applies to the following, except for the measurement provisions:
 - investment property held by the lessee and measured at fair value (IAS 40); investment property provided by lessors under operating leases, biological assets under IAS41



Interpretations on what is a lease

- » Usually straightforward, but substance must prevail over form. So the IASB issued interpretations.
- » IFRIC 4: “Determining whether an arrangement contains a lease.”
- » SIC 27; “Evaluating the substance of transactions under the legal form of a lease”
- » These interpretations do not try to classify the resulting leases into finance or operating



Classification: finance leases

- » Determining whether the lease transfers to the lessee substantially all the risks and rewards incident to ownership.
- » Classification made at inception.
- » List of indicators leading normally to finance classification provided in the standard.
- » No quantitative criteria, no “bright lines”



Indicators of finance leases

- » Transfer of ownership at the end of the lease period
- » Purchase option for the lessee at a price that the exercise of the option is reasonably certain
- » Lease term for the major part of the asset's economic life , even if ownership not transferred
- » At inception, present value of minimum lease payments equal to at least fair value of asset.
- » Leased asset very specific to lessee's use.



Other indicators of finance lease

- » If cancellable by lessee, lessor's losses born by lessee.
- » Fair value variations of the residual fall to the lessee.
- » Lessee entitled to renewal of the lease for a rent substantially below market
- » Other, when a lease includes land and building, classification of the two elements is made separately. Minimum lease payments allocated between the two in proportion to relative values of the leasehold interests.



Accounting for operating leases (lessee)

- » Lease payments recognized as an expense in the P&L statement over the lease term, on a straight line basis, unless another systematic basis better reflects the lessee's benefits
- » Incentives received by lessee for new or renewed leases recognized as a reduction of rental expense over the lease term (SIC 15)
- » No asset, nor liability on the balance sheet, except short term accruals.



Accounting for operating leases (lessor)

- » The leased asset remains in the balance sheet of the lessor and is treated in the same way as a similar owned asset (depreciation/amortization)
- » Lease income is recognized in income on a straight line basis over the lease term, unless another systematic basis is a better representation of the consumption of the leased asset.
- » Costs, including depreciation, are recognized as an expense.
- » Initial direct costs added to carrying amount of leased asset and recognized as an expense on the basis of lease income.



Accounting for finance leases (lessee)

- » **1:** At commencement of lease term, finance lease recognized as an asset and as a liability, at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease or at the entity's incremental borrowing rate.)
- » **2:** Lease payments apportioned between interest and repayment of outstanding liability. (Allocation to produce a constant periodic rate of interest on the remaining liability.)
- » **3:** Depreciation similar to owned assets. If no certainty the asset will eventually be owned by the lessee, depreciation on the shorter of lease term or life of the asset.



Simple example of comparative lessee accounting

- » Lease term: 6 years. Fair value of leased asset: 1,000
- » Annual rent: 200
- » IF OPERATING LEASE
 - » Expense: 200 per year. No Balance sheet amounts.
- » IF FINANCE LEASE
 - » Day one. Asset: 1,000 Liability 1,000
 - » End of year one: Asset: 833 Liability: 840
 - » P&L effect: 207, Incl: Interest: 40
 - » Depreciation: 167



Accounting for finance leases (lessor)

- » At commencement, recognition of a receivable, at the amount of the net investment in the lease.
- » Finance income recognized based reflecting a constant periodic rate of return on the net investment outstanding.
- » Manufacturers or dealer lessors should include selling profit or loss in the same period as they would for an outright sale.
- » Initial and direct incremental costs incurred in negotiating leases must be recognized over the lease term, except for manufacturers / dealer lessors where recognition as expense is matched with selling profit



Sale and leaseback transactions

- » The owner of an asset may sell it and get back the right to use the asset under a lease.
- » If the lease is a finance lease, the gain on the sale is deferred and amortized over the lease term.
- » If the lease is an operating lease and the sale is at fair value, profit or loss immediately recognized. Same if sale is below fair value, except if loss compensated by future rentals below market price. If sale above fair value, excess deferred and amortized over period of use.



Leases disclosures

- » In addition to IFRS 7, specific disclosures for lessors and lessees.
- » Amounts of minimum lease payments and their present value at balance sheet date, for the next
 - » Year, years 2 to 5, beyond 5 years. (lessees)
- » Contingent rent recognized as an expense (lessees)
- » Carrying amount of asset (Finance lease lessees)
- » General description of leasing arrangements.
- » Total future minimum sublease income under noncancellable subleases
- » Unearned finance income (finance lease lessor)
- » Unguaranteed residual values (finance lease lessors)
- » Accumulated allowance for uncollectible lease payments receivable. (finance lease lessors)



IAS 17 Quiz

» What type of lease is presumed, when the present value of minimum lease payments is approximately equal to the fair value of the lease assets?

1. Finance lease
2. Operating lease



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IAS 17 Quiz (continued)

- » When a lease transfers substantially all the risks and rewards of ownership to lessee, this is called...
1. A finance lease
 2. An operating lease
 3. A buy-to-let agreement
 4. A rental agreement



IAS 17 Quiz (continued)

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Future replacement of IAS 17

- » Deliberations now over (June 2015) for a new standard replacing IAS 17. The drafting has started.
- » Most changes will affect accounting by the lessee.
 - » All leases should be recognized on the Balance Sheet as a right of use of the underlying asset. This right will be amortized in the same way as an owned asset.
 - » The corresponding liability will also be treated as in the former finance lease model.
 - » Thus, the operating lease model for a lessee will practically have disappeared except for leases no longer than 12 months (not renewable) and those of insignificant amounts.
- » By contrast, lessor accounting will be almost unaffected.
 - » The new standard will also distinguish within a contract the lease part from other transactions, such as services that will be treated under another standard (e.g. IFRS 15.)