IAS 17 Leases - A Closer Look

Muthupandian, K S

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IAS 17,
Leases
– A Closer Look

K.S.Muthupandian*

International Accounting Standard (IAS) 17, *Leases,* prescribes the accounting treatment for Leases. In October 1980, the International Accounting Standards Committee (IASC) issued the Exposure Draft E19, *Accounting for Leases*. In September 1982, the IASC issued IAS 17, *Accounting for Leases,* effective from January 1, 1984. In 1994, the IASC reformatted the IAS 17 (1982). In April 1997, the IASC issued Exposure Draft E56, *Leases.* The IASC issued revised IAS 17, *Leases,* in December 1997. The effective date of IAS 17 (1997) was fixed as January 1, 1999. On December 18, 2003, the International Accounting Standards Board (IASB), as part of an improvement project, issued the revised version of IAS 17, which supersedes IAS 17 (1997). The revised IAS 17 (2003), *Leases,* became effective for financial statements covering periods beginning on or after January 1, 2005.

Objective

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

Scope and Application

IAS 17 applies to accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

***M.Com., AICWA and Member of Tamil Nadu State Treasuries and Accounts Service, presently working as Treasury Officer, Ramanathapuram District, Tamil Nadu. Email: ksmuthupandian@ymail.com / ksmuthupandian@gmail.com**

However, IAS 17 shall not be applied as the basis of measurement for the following leased assets:
(a) property held by lessees, that is accounted for as investment property (IAS 40, *Investment property*);
(b) investment property provided by lessors under operating leases (IAS 40);
(c) biological assets held by lessees under finance leases (IAS 41, *Agriculture*); or
(d) biological assets provided by lessors under operating leases (IAS 41).

IAS 17 applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. IAS 17 does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Classification of Leases

The classification of leases adopted in IAS 17 is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership. Classification is made at the inception of the lease.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
(d) 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; and
(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications being made.
Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

In classifying a lease of land and buildings, land and buildings elements would normally be separately. The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values. The land element is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17. However, separate measurement of the land and buildings elements is not required if the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted.

Key Definitions

A **lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

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.

A **non-cancellable lease** is a lease that is cancellable only:
(a) upon the occurrence of some remote contingency;
(b) with the permission of the lessor;
(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:
(a) a lease is classified as either an operating or a finance lease; and
(b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The **commencement of the lease term** is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e. the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

The **lease term** is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:
(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
(b) for a lessor, any residual value guaranteed to the lessor by:
(i) the lessee;
(ii) a party related to the lessee; or
(iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Economic life is either:
(a) the period over which an asset is expected to be economically usable by one or more users; or
(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:
(a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
(b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

Gross investment in the lease is the aggregate of:
(a) the minimum lease payments receivable by the lessor under a finance lease; and
(b) any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:
(a) the gross investment in the lease; and
(b) the net investment in the lease.

The **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of:
(a) the minimum lease payments and
(b) the unguaranteed residual value to be equal to the sum of:
(i) the fair value of the leased asset and
(ii) any initial direct costs of the lessor.

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).

Measurement in the financial statements of Lessees

Financial leases - Initial recognition

• At the commencement of the lease term, finance leases are recognised as assets and liabilities at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments each determined at the inception of the lease.
• The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee’s incremental borrowing rate is used.
• Any initial direct costs of the lessee are added to the amount recognised as an asset.

Financial leases - Subsequent measurement

• Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability.
• The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.
• Contingent rents are charged as expenses in the periods in which they are incurred.
• The depreciation policy for depreciable leased assets is to be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets*.
• If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term and its useful life.

Operating leases - Recognition

• Lease payments are recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Measurement in the financial statements of Lessors

Financial leases - Initial recognition

• Assets held under a finance lease are presented as a receivable at an amount equal to the net investment in the lease.

Financial leases - Subsequent measurement

• Finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.
• Manufacturer or dealer lessors recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales. If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged. Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognized.
• An asset under a finance lease that is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with International Financial Reporting Standard (IFRS) 5, *Non-Current Assets Held For Sale And Discontinued Operations* shall be accounted for in accordance with that IFRS.

Operating leases - Recognition

• Assets subject to operating leases are presented in the balance sheet according to the nature of the asset.
• Lease income from operating leases is recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.
• Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased assert and recognised as an expense over the lease term on the same basis as the lease income.
• The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with IAS 16 and IAS 38.

Prescribed Disclosures

Lessees - Finance Lease

Lessees shall, in addition to meeting the requirements of IFRS 7, *Financial instruments: Disclosures* make the following disclosures for finance leases:
(a) for each class of asset, the net carrying amount at the balance sheet date;
(b) a reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
(i) not later than one year (next year);
(ii) later than one year and not later than five years (years 2 through 5 combined);
(iii) later than five years;
(c) contingent rents recognised as an expense in the period;
(d) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;
(e) a general description of the lessee's material leasing arrangements, including, but not limited to, the following:
(i) the basis on which contingent rent payable is determined;
(ii) the existence and terms of renewal or purchase options and escalation clauses; and
(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Lessees - Operating Lease

Lessees shall, in addition to meeting the requirements of IFRS 7, make the following disclosures for operating leases:
(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
(i) not later than one year (next year);
(ii) later than one year and not later than five years (years 2 through 5 combined);
(iii) later than five years;
(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;
(c) lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments;
(d) a general description of the lessee's significant leasing arrangements, including, but not limited to, the following:
(i) the basis on which contingent rent payable is determined;
(ii) the existence and terms of renewal or purchase options and escalation clauses; and
(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt and further leasing.

Lessors - Finance Lease

Lessors shall, in addition to meeting the requirements in IFRS 7, disclose the following for finance leases:
(a) a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
(i) not later than one year (next year);
(ii) later than one year and not later than five years (years 2 through 5 combined);
(iii) later than five years;
(b) unearned finance income;
(c) the unguaranteed residual values accruing to the benefit of the lessor;
(d) the accumulated allowance for uncollectible minimum lease payments receivable;
(e) contingent rents recognised as income in the period;
(f) a general description of the lessor's material leasing arrangements.

Lessors - Operating Lease

Lessors shall, in addition to meeting the requirements of IFRS 7, disclose the following for operating leases:

(a) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

(i) not later than one year (next year);
(ii) later than one year and not later than five years (years 2 through 5 combined);
(iii) later than five years;
(b) total contingent rents recognised as income in the period;
(c) a general description of the lessor's leasing arrangements.

Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package.

The accounting treatment of a sale and leaseback transaction by a seller-lessee depends upon the type of lease involved:

• For a sale and leaseback transaction that results in a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortised over the lease term.

• For a sale and leaseback transaction that results in an operating lease:

  • 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 lease payments 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; and
  • if the fair value at the time of the transaction is less than the carrying amount - a loss equal to the difference between the carrying amount and the fair value should be recognised immediately.

SIC Interpretations

The International Financial Reporting Interpretations Committee (IFRIC) and the Standing Interpretation Committee (SIC) of the IASB has issued the following four Interpretations relating to IAS 17:

  • IFRIC 4, *Determining whether an Agreement 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*

In December 2004, the IASB issued IFRIC 4. This interpretation explains that the requirements of IAS 17 have wider applicability than just those agreements described as leases.

On November 30, 2006, the IASB issued IFRIC 12 with the objective to clarify how certain aspects of existing IASB literature are to be applied to service concession arrangements. Service concessions are arrangements whereby a government or other public sector entity grants contracts for the supply of public services—such as roads, bridges, tunnels, airports, prisons and energy and water supply and distribution facilities—to private sector operators. Control of the assets remains in public hands but the private sector operator is responsible for construction activities, as well as for operating and maintaining the public sector infrastructure. IFRIC 12 addresses how service concession operators should apply existing IFRSs to account for the obligations they undertake and rights they receive in service concession arrangements.

SIC 15 was issued in July 1999 and it clarifies the recognition of incentives related to operating leases by both the lessee and lessor. The interpretation indicates that lease incentives (such as rent-free periods or contributions by the lessor to the lessee's relocation) should be considered an integral part of the consideration for the use of the leased asset.

SIC 27 was issued in December 2001 and addresses issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease. The provisions of SIC 27 include:

> 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. In this respect, SIC 27 includes a list of indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under IAS 17.
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> If an arrangement does not meet the definition of a lease, SIC 27 addresses whether a separate investment account and lease payment obligation that might exist represent assets and liabilities of the enterprise; how the enterprise should account for other obligations resulting from the arrangement; and how the enterprise should account for a fee it might receive from an Investor. SIC 27 includes a list of indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and should not be recognised by the enterprise.
>
> A series of transactions that involve the legal form of a lease is linked, and therefore should be accounted for as one transaction, when the overall economic effect cannot be understood without reference to the series of transactions as a whole.

IASB-FASB Joint Project on Lease Accounting

In February 2006, the IASB and the United States Financial Accounting Standards Board (FASB) issued a Memorandum of Understanding (MoU) that described a joint work plan to expedite global convergence in accounting standards and that established a series of milestones to be reached by 2008. The leases project is part of the 2006 MoU. Under the 2006 MoU, the IASB and the FASB agreed to consider and make a decision about the scope and timing of a potential leasing project by 2008. This goal was achieved when the IASB and the FASB added the leasing project to their respective agendas on July 19, 2006.

FASB Statement No. 13 (FAS 13), *Accounting for Leases,* issued in 1976, provides guidance on accounting for leases for both lessors and lessees. According to the provisions of FAS 13, a lessee should recognize both an asset and a liability for a lease that transfers substantially all benefits and risks incident to the ownership of property, and a lessor should recognize such a lease as a sale or financing. Under FAS 13, a lease that does not transfer substantially all benefits and risks incident to the ownership of property is classified as an operating lease by the lessee. Under operating lease classification, the lessee does not recognize any elements of the lease on its balance sheet (that is, it does not recognize an asset for the right to use the leased item or a related liability for the future lease payments); rather, the lessee recognizes rental expense as it becomes payable.

IAS 17 was very similar to FAS 13 as it was based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Although IAS 17 has been amended several times, its most recent version retains the fundamental approach to the accounting for leases contained in the original standard.

Leasing is a major international industry, and a very important source of finance for a wide range of entities. Consequently, the IASB believes that it is important to seek the views of both users and preparers of financial statements as the project progresses. The IASB and FASB have therefore established a joint working group for this project. On December 8, 2006, the IASB and the FASB announced the membership of a new international working group that will help the boards in their joint project on lease accounting. The FASB and the IASB announced the joint project, "to comprehensively reconsider the guidance in FAS 13, *Accounting for Leases* and IAS 17, *Leases*……to ensure that investors and other users of financial statements are provided useful, transparent and complete information about leases…." The joint project involves comprehensive reconsideration of all aspects of lease accounting and is expected to lead to a fundamental changes in how lessees and lessors account for leases.

The Boards updated the 2006 MoU at the April 2008 joint meeting. As part of the updated MoU, the leases project's estimated completion date is 2011.

The draft Discussion Paper (DP) – which has not been approved by the FASB or the IASB – would express a preliminary view of the two Boards in favour of replacing the current lease accounting model with a new model.

The current model classifies leases as finance leases or operating leases, with the former accounted for as, in substance, financed purchases of the leased asset. Under the proposed new model, a lessee would recognise as assets and liabilities all material rights and obligations arising in all lease contracts, including those rights and obligations that arise under leases currently classified as operating leases.

Thus, a lessee would recognise:

- an asset representing its right to use the leased item for the lease term, and
- a liability for its obligation to pay rentals.

The operating and finance lease classifications would be eliminated.

In January 2009, the FASB has made the decision that lessor accounting (including subleases) should be further analysed and included as a high level discussion in the DP with specific questions, but without changing the scope of the DP. The FASB has also discussed whether in-substance purchases should be within the scope of the project, but decided no change in scope. Furthermore, FASB discussed how a right-of-use model as proposed for lessees in the DP could be applied to lessor and decided that its DP should have a high-level discussion of lessor accounting. In this situation, the IASB decided to issue the IASB DP in the first quarter of 2009 and publish any output from the FASB as a supplementary DP.

Following publication of the DP, the Boards will move towards publication of an exposure draft on lease accounting. This exposure draft will take into account comments received from constituents on the DP. The staff of the Boards expects a final standard on lease accounting to be published in the second quarter of 2011.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 17 is AS 19, *Leases.* AS 19 is based on the earlier IAS 17 (1997). IAS 17 has been revised in 2004. The major differences between IAS 17 and AS 19 are conceptual differences and described hereinafter:
1. Keeping in view the peculiar land lease practices in the country, lease agreements to use lands are specifically excluded from the scope of AS 19 whereas IAS 17 does not contain this exclusion.
2. IAS 17 specifically provides that the Standard shall not be applied as the basis of measurement for:
(a) property held by lessees that is accounted for as investment property;
(b) investment property provided by lessors under operating leases;
(c) biological assets held by lessees under finance leases; or

(d) biological assets provided by lessors under operating leases.
However, AS 19 does not exclude the above from its scope.
3. AS 19 specifically prohibits upward revision in estimate of unguaranteed residual value during the lease term. However IAS 17 does not prohibit the same.
4. As per IAS 17 initial direct costs incurred by a lessor other than a manufacturer or dealer lessor have to be included in amount of lease receivable in the case of finance lease resulting in reduced amount of income to be recognised over lease term and in the carrying amount of the asset in the case of operating lease as to expense it over the lease term on the same basis as the lease income. However, as per AS 19, these can be either charged off at the time of incurrence in the statement of profit and loss or can be amortised over the lease period.

Conclusion

Leasing is a global business, and differences in accounting standards can lead to considerable non-comparability. The primary objective of the leases project is to develop a new model for the recognition of assets and liabilities arising under lease contracts to ensure that financial statements provide useful, transparent, and complete information about leasing transactions to investors and other users of financial statements. The IASB-FASB joint project is likely to lead to a new accounting standard that will abolish the distinction between operating and finance leases and require all companies to show the asset and liability created by a lease on the balance sheet as is currently required only for finance leases, so even if unlisted companies do not presently have to comply with IAS 17, the writing is on the wall.

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