# Leasing under IFRS

# Crystallising soon?

**There are lots of rumours and even more uncertainty on the effect of IFRS on the car lease market. Combined with the current state of the economy and the impact thereof on the car lease market some even suggest that it will reshape the car lease market. This article explains how the lease classification decision affects financial statements and provides an update on the status of the new standard and its interpretation in terms of leasing.**

Bart VANHAM

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 decision as to how the lease should be classified (i.e. finance or operating lease) should be made at the inception of the lease (the earlier than the date of the lease agreement and the date of commitment), based on the information available at that date.

The lease's classification should not be revised at a later date for changes in estimates or other assumptions made at the inception of the lease. If changes are made to the lease's provisions, other than a renewal of the lease, in a manner that would have resulted in a different classification of the lease, the revised agreement should be regarded as a new agreement over its term (for example, an upward adjustment to the lease payments would indicate that from that date onwards there is a new lease).

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## Lease classification and accounting

IFRS distinguishes between finance and operating leases, based on a risks and rewards model. Management needs to analyse the economics of the agreement in order to determine how to classify a lease.

The classification depends on the extent to which the lessor has transferred or the lessee has obtained substantially all risks and rewards associated with the ownership of a leased asset.

A finance lease is 'a lease that transfers substantially all the risks and rewards incidental to the ownership of the asset' irrespective of the transfer of title. All other leases are classified as operating leases.

Both the lessor and the lessee must undertake a thorough analysis of the facts and circumstances surrounding the leased asset and the lease agreement in order to establish whether there has been a transfer of 'substantially all' risks and rewards from the lessor or receipt of substantially alls risks and rewards by the lessee.

Where the lessor has little or no residual exposure in the lease transaction and looks solely to the contracted rental stream to pay back his investment, funding costs and margin, the only risks he will have retained will be the types of risk normally associated with financing transactions (i.e. credit risk). As there are substantially no risks retained relating to the physical asset, the contract will be a finance lease. Contrary to the current general interpretation, the form or the way the agreement has been worded and the terms used in the agreement have no influence.

In contrast, where the lessor

retains significant risks relating to the physical asset in terms of residual risk or performance risk, then substantially all the risks and rewards could not have passed to the lessee. For example, under some three-year contract hire agreement for a car the lessor may well take all the residual risks and potential gains of the future sale of the vehicle at the end of the lease term. Failure to realise the expected residual value, which might amount to 35-45% of the lessor's initial investment, would have a serious adverse effect on the lessor's profitability. In these circumstances it should be fairly obvious from the nature and size of the lessor's residual risk exposure that 'substantially all the risks and rewards of ownership' could not have passed to the lessee. This is not to say that the lessee does not have substantial risks under the three-year operating lease of a vehicle: the lessee must still make the lease payments under the contract terms whether or not the asset becomes surplus to his needs, or cheaper or more attractive alternative assets become available, or the asset does not perform to expectations. However, the lessee's position is quite different from that of having legal ownership in that he avoids the uncertainty associated with the realisation of residual value, and he only has the use of the asset for a period that is significantly shorter than its full economic life.

**Figure 1: Lease Classification**

| LEASE TYPE | IN THE FINANCIAL STATEMENTS OF: | BALANCE SHEET | INCOME STATEMENT |
|---|---|---|---|
| FINANCE | Lessee | - Asset<br>- Accumulated depreciation<br>- Lease obligation<br>- Reduction in lease obligation | - Depreciation expense<br>- Finance charge |
| FINANCE | Lessor | - Receivable<br>- Reduction in receivable | - Finance income |
| FINANCE | Dealer/manufacturer lessor | - Receivable<br>- Reduction in receivable | - Finance income<br>- Revenue / cost of sales |
| OPERATING | Lessee | Off balance sheet | - Rental expense |
| OPERATING | Lessor | - Asset<br>- Accumulated depreciation | - Rental income<br>- Depreciation expense |

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IFRS guidance on lease transactions is provided through IAS 17 "Leases"; IFRIC 4 "Determining whether an arrangements contains a lease"; SIC-15 "Operating leases – incentives" and SIC-27 "Evaluating the substance of the transactions involving the legal form of a lease".

IAS 17 deals with lease classification and gives examples and indicators of situations that may lead to a finance lease classification. For example:

1. The lessee obtains ownership of the leased asset by the end of the lease term.
2. The lessee has a purchase option at a price significantly below market value.
3. The lease term is for a major part of the economic life of the asset, even if title is not transferred.
4. At the inception of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. The key areas to determine in performing the present value test are the:
   - lease term;
   - minimum lease payments; and
   - appropriate rate to discount the minimum lease payments.
5. The leased assets are of such specialised nature that only the lessee can use them without major modification.
6. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are born by the lessee.
7. Gains and losses from the fluctuation in the fair value of the residual value accrue to the lessee.
8. The lessee has the ability to continue to lease for a secondary period at a rent substantially lower than the market rent.

The above are a means of determining whether substantially all the risks and rewards of ownership are transferred, however they should be disregarded where it is clear from the other features that the lease does not transfer substantially all the risks and rewards. For example, the lessor leases a car to a lessee for 3 years and the lessee has an option to buy it at its fair value at the end of the lease term.

Management should make such judgements consistently between all leasing agreements and document their analyses and conclusions.

All the users of financial statements need to be aware of the decision process for classifying a lease since management's decisions on lease classification affects the relevant accounting treatment, which is as follows (see Figure 1):

## The future of accounting for leases

It is worth noting that the standards setters are concerned about the current guidance (developed some 25 years ago and criticised for allowing similar transactions to be accounted for in very different ways).

In a joint project between the International Accounting

Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) all aspects of lease accounting will be reconsidered. The IASB and FASB have published a discussion paper in March 2009 with new views on the accounting of leases for lessees. The objective of this discussion paper is to create a common standard for IFRS and US-GAAP on lease accounting ensuring that assets and liabilities arising from lease contracts are recognised in the statement of financial position. Currently only finance leases are 'on balance', where operating leases are 'off balance'.
All leases will result in assets comprising to the right-of-use of the asset and in liabilities for the obligation to pay rentals. As per the discussion paper it will be irrelevant whether the risks and rewards of the leased asset have been transferred to the lessee. This will therefore impact liquidity and other relevant financial ratios as both assets and liabilities will be affected.
On initial recognition the asset will equal the net present value of the lease liability. Subsequently the asset and the liability should be measured on an amortised cost-basis. Therefore, for a lease that under the current guidance of IAS 17 is classified as operating lease, the expenses (being depreciation of the right to use asset and interest expense on the outstanding liability) to be recognised under the proposed guidance at the beginning will be higher than those at the end of the lease period.

## A complex and labour intensive approach

We fully understand the objectives of the IASB/FASB to improve transparency and reduce complexity of financial statements. However the proposed approach is very complex and labour intensive when applied to full leasing solutions for smaller assets such as company cars and could add a high level of subjectivity in financial statements. For this reason we have urged the IASB/FASB to conduct a proper business impact analysis to ensure the benefits of the new approach clearly outweigh the associated costs and complexity.

**Erik Henstra, Global Coordination Director (LeasePlan International).**

## Major reservations concerning the IAS 17 Discussion paper

We believe that the proposed changes in accounting place an unreasonable administrative burden on companies who use full service vehicle leasing as a simple, low cost, outsourced solution. The complexity within the discussion paper (adjusting interest rates, contract duration, depreciation) is not justified by the potential economic benefit. The changes will result in significant balance sheet and income statement volatility. It is noted that no cost-benefit analysis has yet been conducted. In addition, the document fails to address properly the subject of lessor accounting.

**Mike Masterson, CFO (ALD Automotive).**

In the discussion paper only the accounting for the lessee is covered in detailed.
The discussion paper also includes a discussion of some of the issues in any future new standard on lessor accounting. In more detail it provides two possible approaches for the lessor (i) derecognition of the leased item; or (ii) recognition of a performance obligation by the lessor.
Comments on the discussion paper were submitted on 17 July 2009. An exposure draft is expected in the first half of 2010 and is expected that will be finalised in 2011.
Lease classification is a complicated area. IASB and the FASB seem to go for a solution that will better reflect the economic substance (and therefore avoid the current IAS 17 guidance of all or nothing on the balance sheet) where the lessee will need to recognise the asset and the liability in their financial statements, impacting the financial ratio's.

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