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Leasing industry poised for a big change as 50 years old lease accounting standard changes

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1. Introduction

The International Accounting Standards Board (IASB), and the US Financial Accounting Standards Board (FASB), the two major accounting standard setters globally, came to the conclusion of a project that was initiated several years back, as a new accounting standard, IFRS 16, was issued on 14th January 2016. The new standard, to be effective from 1st January 2019, replaces IAS 17 that has its roots going back to about 50 years.

The crux of the new standard is that while lessor accounting virtually remains unchanged, lessee accounting has changed drastically. The current accounting is based on whether the lease is a financial lease or operating lease. Under current accounting standard, assets acquired on financial leases are not off-the-balance sheet of the lessee – there is an asset as well as a corresponding liability recognised by the lessee. Under the new accounting standard, the distinction between financial and operating lease goes away completely, as far as lessee accounting is concerned, as every lease, subject to some exceptions, will be capitalised on the books of the lessee.

Over the years, the leasing industry has grown under the shadow of the accounting standards. Lessors practice either financial leases, and accept their parity with secured loans in terms of accounting standards. Or, lessors devise and structure operating leases, and keep them off-the-balance sheet of the lessee. Several leasing players even structure a lease which is a hybrid – operating lease for the lessee and financial lease for the lessor. Not only has the product development within the leasing industry been shaped by the accounting standards, even the taxation treatment in many countries is driven by whether the lease is a financial lease or an operating lease. Regulations on leasing in many countries, including those pertaining to cross-border transactions, are also based on the same distinction.

Now that the distinction goes, from lessee perspective, lessees will be indifferent between financial and operating lease treatment, and therefore, the off-balance sheet motivation for leases becomes insignificant. Is this a blow to the leasing industry? Perhaps not, as leasing will continue to focus on its economics rather than any reporting arbitrage. Also, the ability to structure a lease as an off-balance sheet lease becomes irrelevant. Therefore, all attention will henceforth be on cost, convenience and services provided by the lessor.

2. History of lease accounting standards

Accounting for lease has been a concern for the leasing industry from very beginning of the industry. But the real need for a recognised accounting standard was felt in the year 1840, when one of the railway giants of the industry was strongly criticised for non-disclosure of long term lease obligation in the balance sheet of the company, which was just a loan taken by the company in the form of a lease.

The assets and liabilities arising out of the lease transactions were never reflected in the books of the lessees as according to the then standards, on book recognition was given only to those resources which was legally owned by the entity disclosing it and not to the ownership of "right to use", similarly in case of liabilities only those were recognised in books which were legally to other by the entity. Again sometimes leases were regarded as executory contracts or partially unperformed contracts and were not recognised in the books of the lessee, both ways the true and fair of the books of the lessee were compromised and this was a serious issue which need to addressed the soonest.

It was in the year 1964 when the Accounting Principles Board (APB) issued its opinion on the reporting of leases in the financial statements of the lessee, again in the year 1966 APB issued its opinion 7 on the reporting of leases in the financial statements of the lessors, then in the year 1972, APB issued its opinion 27 on Accounting for Lease Transactions by Manufacturer or Dealer Lessors and in the year 1973, opinion 31 was released which listed the Disclosure requirements of Lease Commitments by Lessees, based on these opinion Accounting Standard 13 was established by the FASB in the year 1976, which classified leases as capital lease and operating lease, from the standpoint of the lessee. The criteria for classification of leases under capital lease and operating was specified in paragraph 7 of the FASB standard 13. Whereas from the lessor's point of view, leases could be of the following types - sales-type lease, direct financing lease, leveraged lease and operating lease, the same was dealt in paragraph 6 of the FASB standard 13.

In the year 1982, the IASC established the IAS 17 Accounting for leases, which is the international accounting standard for leases and the same was effective from the 1984. IAS 17 was a unified document published to prescribe the lessees and lessors, the appropriate accounting policies and disclosures to adopt in relation to finance and operating leases.

The IAS was further reformatted in the year 1994 to make minor adjustments in the standard and bring in simplicity in the accounting procedures, again in the 1997 Exposure Draft E56, Leases was issued, which led to the reincarnation of the IAS 17 in the form IAS 17 Leases and same was effective form 1999, this was a major development in the accounting procedures for leases worldwide and also took care of the modern lease contracts like sale and leaseback transactions etc.

The new IAS was revised in the year 2003 by the IASB and the same was effective form 2005, then again in the year 2009 the IAS was again amended for classification of land leases and the same was applicable for the year 2010.

The Figure below shows the evolution of lease accounting standard:

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1964: APB's Opinion 5	1976: Accounting Standard 13 of FASB	1982: IAS 17 *Accounting for leases*	1994: IAS 17 *Accounting for leases* reformatted	1999: IAS 17 *Leases - issued*	2005: revised IAS 17 *Leases* – becomes effective	2009: IAS 17 *Leases* – amended	2019: IFRS 16 becomes effective
Opinion for reporting of leases in books of lessee	The first accounting standard for leasing issues	Accounting Standard 13 succeeded by IAS – 17 issued by IASC	IAS revised to bring in simplicity of accounting procedures	IAS – 17 *Leases* issued by IASC	IAS – 17 *Leases* revised to bring hybrid contracts under the preview of leases	IAS – 17 *Leases* updated to meet changing business requirements	IFRS – 16 to become the new accounting standard for leases

3. Re-write of lease accounting standard

3.1. McGregor's paper on leases[1]

The trace of lease accounting standard, what it is today, was initiated with the Warren McGregor's paper on leases in 1996. This came out as special report titled "Accounting for leases a new approach" which primarily dealt with the recognition by lessees of assets and liabilities arising under lease contracts. This paper highlighted the shortcomings of the then lease accounting standards particularly in regard to the non-recognition in lessee's balance sheet of material assets and liabilities arising from operating lease contracts. The usefulness of the lease accounting standards were further eroded by arrangements which effectively enabled classification of in substance finance leases as off-balance sheet operating leases. The paper pointed out that then lease accounting standard acted as a motivation for generating "standards-driven" transactions for the purpose of securing finance which is "off balance-sheet".

3.2. Impact of major accounting scandals intensified work on the new standard

Major accounting scandals like Enron which eventually led to the enactment of the Sarbanes-Oxley Act, 2002, set a number of new or stricter standards for U.S. public boards, management and public accounting, enhancing the financial disclosures for off-balance-sheet transactions. The Act also required the Securities and Exchange Commission and the controller general to perform various studies. One such report by the SEC in 2005 focused on off-balance-sheet arrangements and made recommendations to FASB for reconsideration of lease accounting standards.

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[1] http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/FASBSR-1996-Leases-New-Approach.pdf

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3.3. Joint project by FASB and IASB

Post the recommendation of the SEC regarding the revision of lease accounting standards in 2005, a project was undertaken jointly by FASB and IASB. The project team carried out team carried out field testing and the IASB discussed the matter with its standing consultative group of users and preparers at a World Standard Setters Meeting[2]. Both the boards worked together to re-deliberate the proposal intensively in light with the 760 comment letters received in 2011. By this time it was very evident that the discussion was leading to new definition of lease, i.e., whether some contracts should be left out of the purview of the lease accounting standards.

3.4. Objections raised by Leaseurope[3]

The IASB faced had a real uphill task to formulate the lease accounting standard, as at first they had to convince the US authorities thereafter they had to face an objection from Leaseurope, which is a leasing association of 16 West European nations, with respect to lease capitalisation by the lessee because of controversy over the right to the capitalized asset and the inherent complication in its application.

3.5. The revamped version of the lease accounting standard

The new lease standard, as it is, despite several recommendations ended up with changes in the manner of lease accounting for the lessee with absolutely no change in the lease accounting for the lessors. The only thing that the new accounting standard offers to the lessors is additional disclosure requirements.

4. Major provisions of the new lease accounting standard:

4.1. Whether the arrangement is a lease:

It was IFRIC 4, which one had to refer to determine whether an arrangement is a lease or not. But with the emergence of the IFRS 16, which supersedes several guidance like IAS 17, IFRIC 17, SIC 15 and SIC 27, determination of lease will now have to be done in accordance with this standard.

The standard contains an elaborate discussion on whether an arrangement is a lease or not. A contract will be considered to be a lease if both the following criteria are established:

1. Conveying the use of a specific asset

As per the standard, if a contract conveys the *right to obtain substantially all of the economic benefits* from the use of an identified asset, throughout the period of use of the same, it can be construed that the contract is a lease.

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[2] Aiming for Global Accounting Standards: The International Accounting Standard by Kees Camfferman, Stephen A. Zeff

[3] http://www.russellbedford.co.id/downloads/resources/8dcbb_PSAK-30.pdf

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The concept of *right to obtain economic benefits* has been dealt in a detailed manner in paragraphs B21 – B23 of the standard. The standard is broad enough to cover economic benefits obtained either directly or indirectly, by using, holding or sub-leasing the identified asset. The term *economic benefit* has been defined to include primary outputs and by-products and any other economic benefit realised from the asset by entering into a commercial transaction with a third party.

The economic benefit, in this case, shall have to be restricted to the extent the same is obtained from the defined scope of right to use the asset.

If a contract limits the right to use the asset only within a particular territory, the economic benefits to be determined for the purpose of lease classification, shall be restricted to the economic benefits arising out of the use of such asset only within the defined territory and not beyond.

Similarly, if a contract limits the right to use the asset only for a particular period, the economic benefits to be determined for the purpose of lease classification, shall be restricted to the economic benefits arising out of the use of such asset only during the defined territory and not beyond.

2. Conveying the right direct the use of a specific asset

Again, if a contract conveys the *right to direct the use* of an identified asset throughout the period of use of the same, the contract shall be treated as a lease.

Further, the standard also talks about the some other factors as well which would establish whether the customer has the right to direct the use of an identified asset and the same have been presented provided below:

a. the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
b. the relevant decisions about how and for what purpose the asset is used are predetermined and:
    i. the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
    ii. the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

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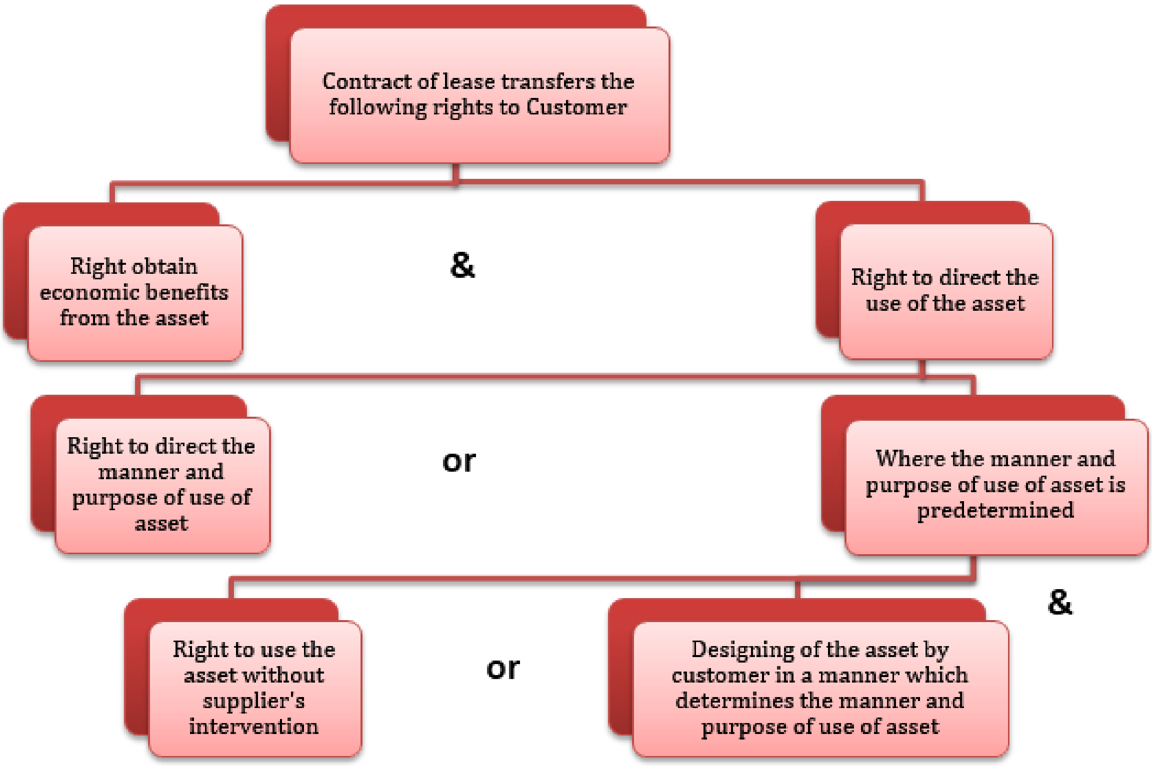
If both of the above points (1 & 2) are satisfied, the contract shall be considered as lease. The above discussion has been summarised graphically below:



4.2. Compound contracts:

Not only does the standard deal with contracts which are leases, it also deals with contracts which have elements of a lease. The standard requires that in such cases, the contract will be split into a lease and a non-lease contract.

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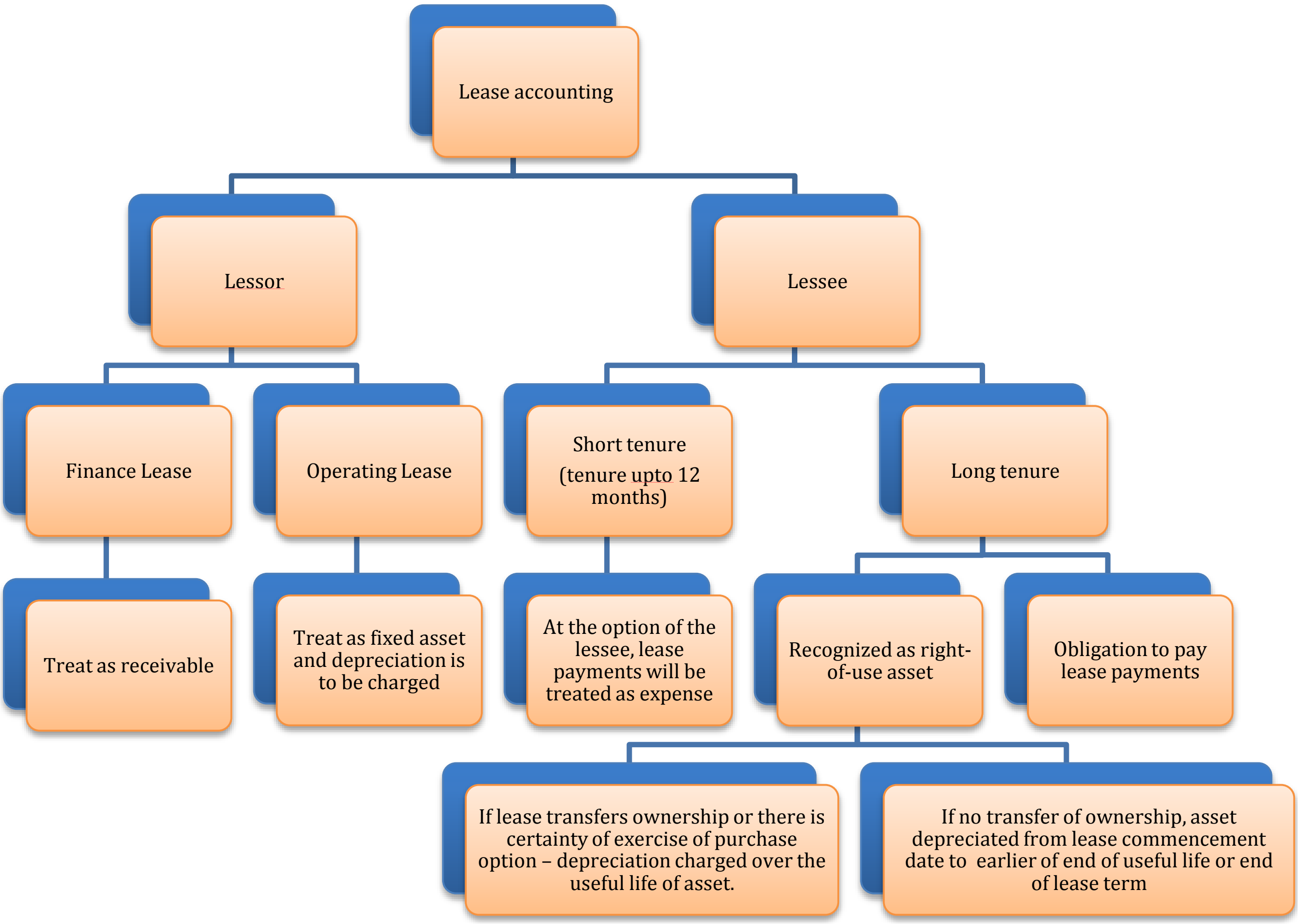
5. Lease accounting

The accounting for leases is graphically represented in the chart below:



6. Lessor accounting

The lease accounting treatment for the lessors has been presented in a tabular form below:

Particulars	Accounting treatment
Finance lease	• **Recognition of the asset –** Assets held under finance lease to be presented as a receivable at an amount equal to the net investment in the lease. • **Recognition of the income –** Finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.
Operating lease	• **Recognition of the asset –** Assets held under operating lease shall have to be capitalised in the books.

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	• **Recognition of the income –** The lease payments from operating leases shall have to be recognised as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. • **Recognition of expenses –** The expenses associated with earning of lease income, like depreciation, shall have to be recognised as expense.

7. Lessee accounting:

The lease accounting treatment for the lessors has been presented in a tabular form below:

Particulars	Accounting Treatment

Right-of-use asset	**Initial Recognition and treatment –**
	On the date of commencement of lease, a lessee shall measure the right-of-use (ROU) asset at Present value of the lease payments discounted at the interest rate implicit in the lease or the incremental borrowing rate
	
	Subsequent measurement and treatment
	• The ROU asset will be depreciated as per the depreciation requirements in IAS 16 *Property, Plant and Equipment*
	  ○ If ownership of the assets will be transferred to the lessee by the end of the lease term or if there is a certainty that the purchase option will exercised by the lessee, the ROU asset will be depreciated over the useful life of the asset
	  ○ In any other case, the ROU asset will be depreciated over the useful life of the asset or the lease term whichever is shorter.
	• Depreciation on the ROU asset will be reflected as a charge in the income statement

Lease liability	**Initial Recognition and treatment** On the date of commencement of lease, a lessee shall measure the lease liability at Present value of the lease payments discounted at the interest rate implicit in the lease or the incremental borrowing rate **Subsequent measurement and treatment** • The carrying amount of the lease liability will increase by the amount of interest accrued on the lease liability • The carrying amount will be reduced on account of the payments made towards the lease liability.

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	• The interest expense on lease liability, being a component of finance cost will be presented separately as a charge in the income statement
Exemptions	At the option of the lessee, he may choose not to apply the accounting requirement under IFRS – 16 to the following – • Short term leases (i.e. leases for a period of 12 months or less) • Leases of low value assets (for e.g. personal computer) Lease payments made for the aforesaid lease of assets will be reflected as an expense, either on straight line basis over the lease term or any other systematic basis, in the income statement
Lease Renewal/Modification	Any lease modification to be accounted for as a separate lease if – • the modification increases the scope of the lease by way of addition of ROU of one or more assets and • there is a corresponding increase in the consideration for lease for increase in scope If the lease modification is not accounted for as a separate lease, the accounting treatment for the same will be as under – • The consideration in respect of the modified lease will be allocated between lease and non-lease component if any. • Alternatively, the lessee may choose not to allocate the consideration between lease and non-lease component and instead account for the entire modification as a lease component. • The lease liability to be remeasured by discounting the revised lease payments using a revised discount rate, which is either the interest rate implicit in the lease or lessee's incremental borrowing rate at the date of modification. If the modification results in a reduction in the scope of lease, the following treatment need to be done – • The carrying amount of the ROU asset to be reduced • Profit/loss on account of reduction in scope of lease to be recognised in profit and loss account • The lease liability to be remeasured in the same manner as done in case of an increase in scope of lease on account of lease modification

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8. Conclusion

The new set of lease accounting standard has hardly any changes to offer to the lessors, except a few additional disclosure requirements, but the same has changed the manner of accounting by the lessee's substantially. The chart below shows the highlights of the accounting treatment by the lessor and lessee under the new standard.