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Understanding the New Lease Accounting Approach

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Introduction

Leasing is an important activity for many entities as a means of gaining access to the assets of obtaining finance, and of reducing an entity's exposure to the risks of asset ownership. The industry since last several years have followed G4+1 approach, linked to Australian scholar Warren McGregor, to lease accounting. It was only after the Enron's scandal in US that there arose need for improvement in the existing lease accounting. Both IASB and FASB have come with an exposure draft on lease accounting to replace the existing lease accounting standards with a completely different approach.

As per the existing lease accounting standard, leases are classified either as Finance Lease or Operating Lease. Finance leases require on-balance sheet treatment whereas operating leases are treated off-balance. This led way to parties in the lease transaction contriving contracts which were in substance finance lease being mechanically fit into the definition of operating lease, wriggling out the definition of finance lease for taking the benefit of off-balance sheet treatment. The IASB and FASB had jointly come up with a new exposure draft on leases on 17th August 2010, which has now been revised. The revised exposure draft will give a new shape to entire industry as it has put an end to the distinction between finance lease and operating lease. Now all leases whose maximum lease term is not twelve months or less will come on the balance sheet without distinguishing between a finance lease and operating lease. Recognition of liability in the books of lessee is compulsorily required for all such leases, which with itself also correspondingly requires recognition of right to use the asset. This would provide a more faithful representation of the financial position of the lessee and, together with enhanced disclosures, greater transparency about the lessee's leverage.

Broad Framework of the exposure draft

- What is a lease ?
- When is Accounting Standard applicable ?
- Measurement of Lease Payments
- Accounting for lease

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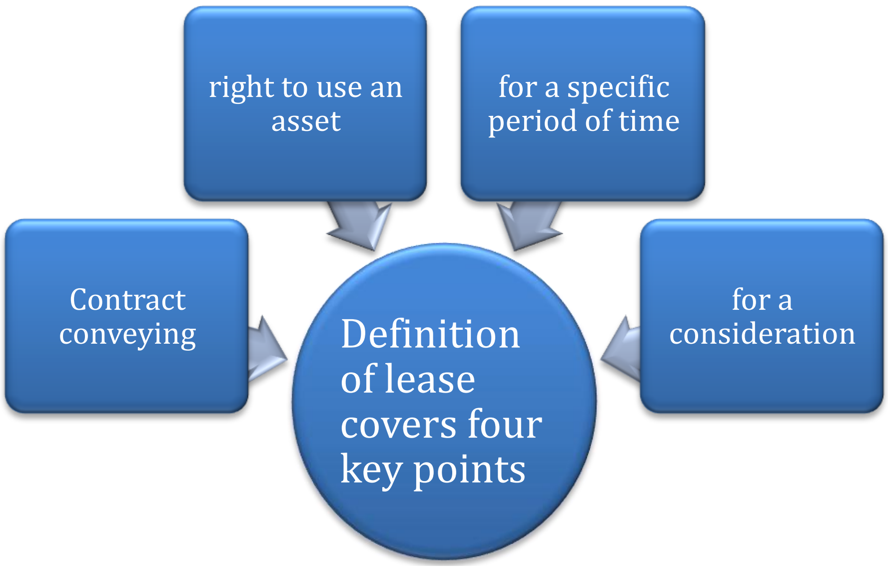
Definition of Lease

The definition of lease covers four key points as depicted below:



This definition of lease has been explained hereunder,

A Lease is defined as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity shall at the very inception of a contract, determine whether the contract is or contains a lease or not. A contract is or contains a lease when twin conditions are satisfied:

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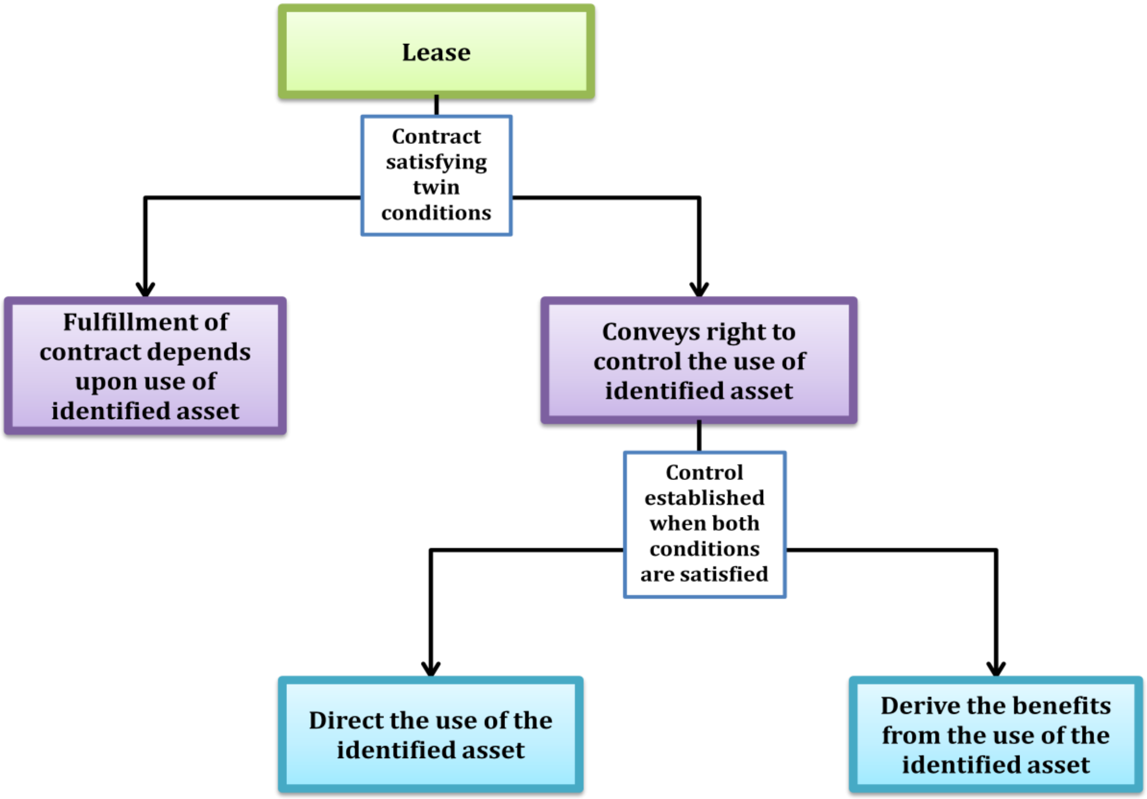

The diagram above has been explained below in details.

(a) The fulfillment of the contract depends on the use of the identified asset:

- An identified asset is an asset which is explicitly specified in a contract.
- Whereas, fulfillment of the contract would not depend on the use of an identified asset explicitly specified in a contract, when the supplier has the substantive right to substitute the asset throughout the term of the contract.
- The supplier may have the substantive right to substitute the asset throughout the term of the contract when the asset is not operating properly or a technical upgrade is required.
- On the other hand even if the asset is not explicitly specified in the contract then also the fulfillment of the contract can depend on the use of an identified asset if the supplier does not have a substantive right to substitute the asset.

(b) The contract conveys the right to control the use of the identified asset. The right to control is established if the customer has the ability to do both of the following, throughout the term of the contract:

- Direct the use of the identified asset: It is the right by which the customer can make decisions about the use of the asset in a manner that would affect the economic benefits derived from such use most significantly.

- Derive the benefits from use of the identified asset: It is the right to obtain substantially all of the potential economic benefits from use of the asset, throughout the term of the contract. Economic benefits from use of an asset can be obtained directly or indirectly in many ways, such as buying, consuming, holding or sub-leasing the asset.

Thus based on the above discussion and throwing light on the illustrations laid down by the board a contract is or contains a lease when it contains the following:

- The contract conveys the lessee the right to use the asset.

- The fulfillment of the contract depends on the use of identified asset. The asset is explicitly specified in the contract and the lessor does not have substantive substitution rights over the asset except in case the asset is not operating properly or when technical upgradation is required.

- The lessee has the right to control the use of the asset.

- The lessee can establish control if it has the ability to direct the use of the asset throughout the term of the contract. This means the lessee has the right to determine how, when and for what purpose the asset is used throughout the lease term.

- To establish control the lessee should also have the ability to derive benefits from the use of the asset throughout the lease term. The lessee should solely derive the benefit from the asset during the lease term. No other party can use the identified asset during the lease term unless the lessee agrees to such use.

- The contract may also contain a non lease component or a service component along with an identified lease component. This does not change the conclusion that the lessee has the right to use the identified asset.

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Lease recognition on component basis: For Composite contracts

The draft also provides the manner in which we can determine the amount paid for each lease component out of the total payments made for a composite contract. A composite contract may consist of lease and non-lease component (such as service contract). Out of the total payments our focus will be determine the payment made for each such lease component. The same can be done in two steps:

Step 1: Identification of lease component

Each lease component has to be separately identified based on the following twin conditions:

- The benefit from use of the asset either on its own or together with other resources that are readily available to the lessee.

and

- The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

Thus if in a contract there is lease of one or more asset firstly we will have to determine whether these assets are separate components or not. Secondly if they are not separate components and is a single component then which is the primary asset. For being identified as a separate component both the conditions as stated above has to be satisfied.

In case the lessee enters into a lease contract where it can benefit from asset either on its own or together with other resources that are readily available *and* where the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract then the assets are identified as separate components.

Whereas when the lessee cannot benefit from the underlying asset without using another asset which is also a part of the contract then these cannot be identified as separate components and are considered as a single component. Among these assets the primary asset has to be determined. The primary asset is the predominant asset for which the lessee has contracted for the right to use. The other asset in the component facilitates the lessee to obtain benefits from use of the primary asset.

Step 2: Recognition of the components identified

Recognition from the Lessor's viewpoint

Once the lessor has identified the lease components in a contract he shall allocate the consideration in the contract in accordance with the requirements of IFRS on Revenue from Contracts with Customers.

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Recognition from the Lessee's viewpoint

Once the lessee has identified the lease components in a contract he shall allocate the consideration in the contract as follows:

- If observable stand-alone prices are available for all the components, the consideration shall be allocated on the basis of the relative stand-alone price of each component. Observable stand-alone price refers to the price that either the lessor or similar suppliers would charge for each component of the contract in a similar lease.

- If observable stand-alone prices are available for one or more components of the contract but not for all of them then the lessee shall allocate the consideration equivalent to the stand-alone price of each component to those components which have observable prices and the remaining components of the contract that do not have observable prices shall be combined and account as a single lease component. The remaining consideration shall be allocated to this single lease component.

  For example, if the consideration for the contract is INR 60000. The contact consists of three components- component 1, component 2 and component 3. Observable stand alone price of only component 1 is available, INR 25000.Then component 1 and 3 shall be considered as a single component and the remaining consideration of INR 35000 shall be allocated to them.

- If observable stand-alone prices are not available for any components of the contract then the lessee shall combine the components and account for them as a single lease component.

Measurement of lease assets and liabilities

The asset and the liability are initially measured at the present value of lease payments. It includes any costs incurred that are directly related to entering into the lease. Thus it includes the following:

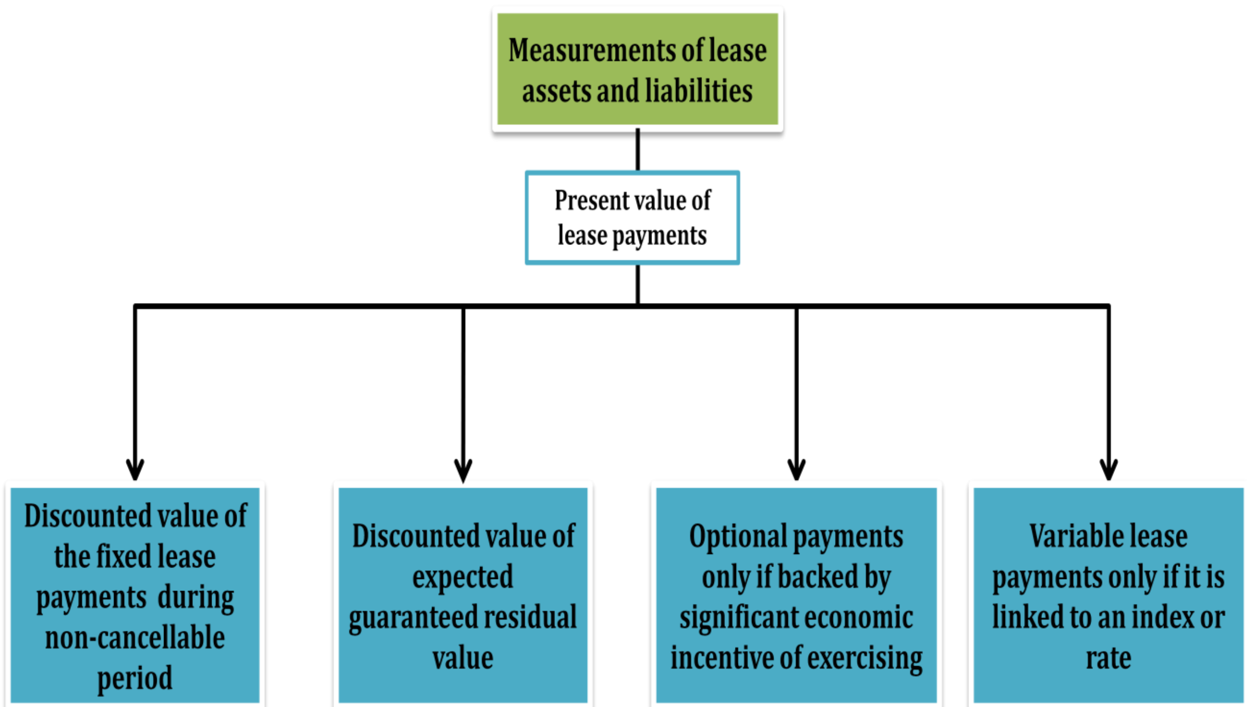
- ➢ Discounted value of the fixed lease payments during the non-cancellable period and expected guaranteed residual value.

- ➢ Optional payments only if there is significant economic incentive to exercise the option.

    - Termination penalties are also recognized at the commencement of the lease term at their present value if there is significant economic incentive to exercise the termination option.

- Purchase price of the underlying asset at the time when purchase option can be availed should be included in the value of right of use of asset, at their present value if there is significant economic incentive to exercise the termination option. Further the right to use of asset is amortized over the useful life of the asset and not only over the lease term.

➢ Variable lease payments only if it is linked to an index or rate. Variable lease payments linked to sales or use are not to be included.



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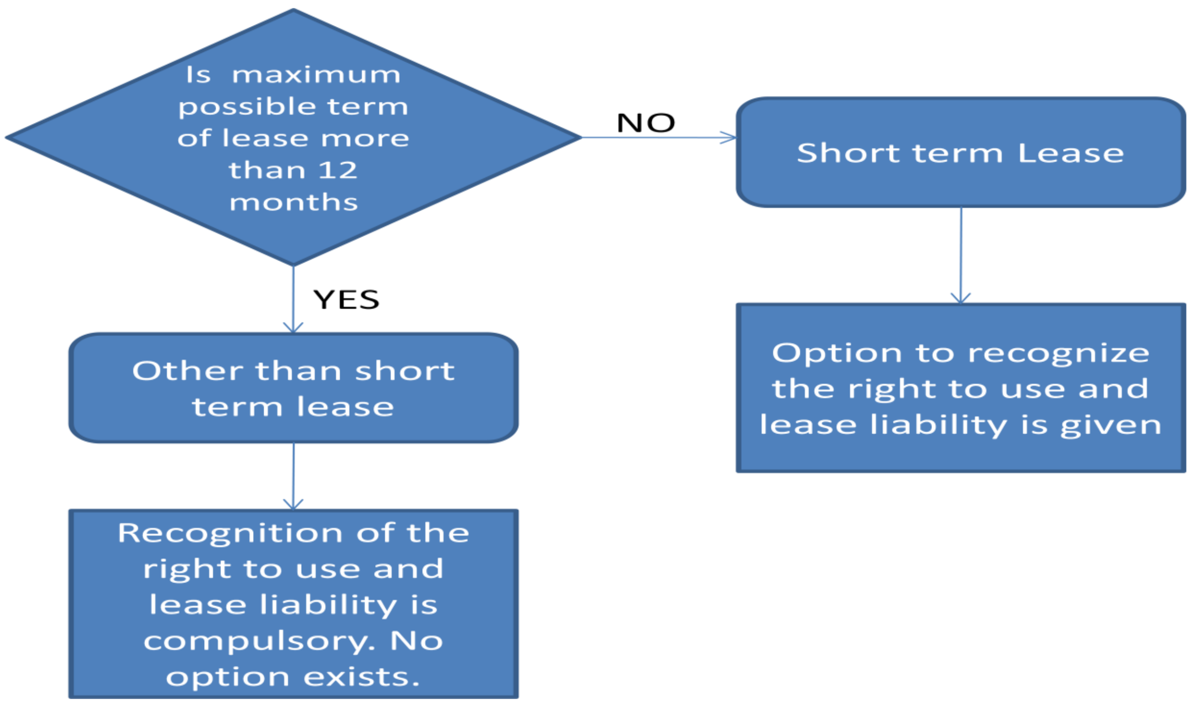
Option available for short term leases



- Recognition of lease in the financial statements is necessary as leases create rights and obligations that meet the definition of an asset and a liability for a lessee and that the recognition of lease assets and liabilities by a lessee would substantially enhance the information provided to users of financial statement.

- The exposure draft has made it compulsory to recognize assets and liabilities for leases having a maximum possible term of more than 12 months.

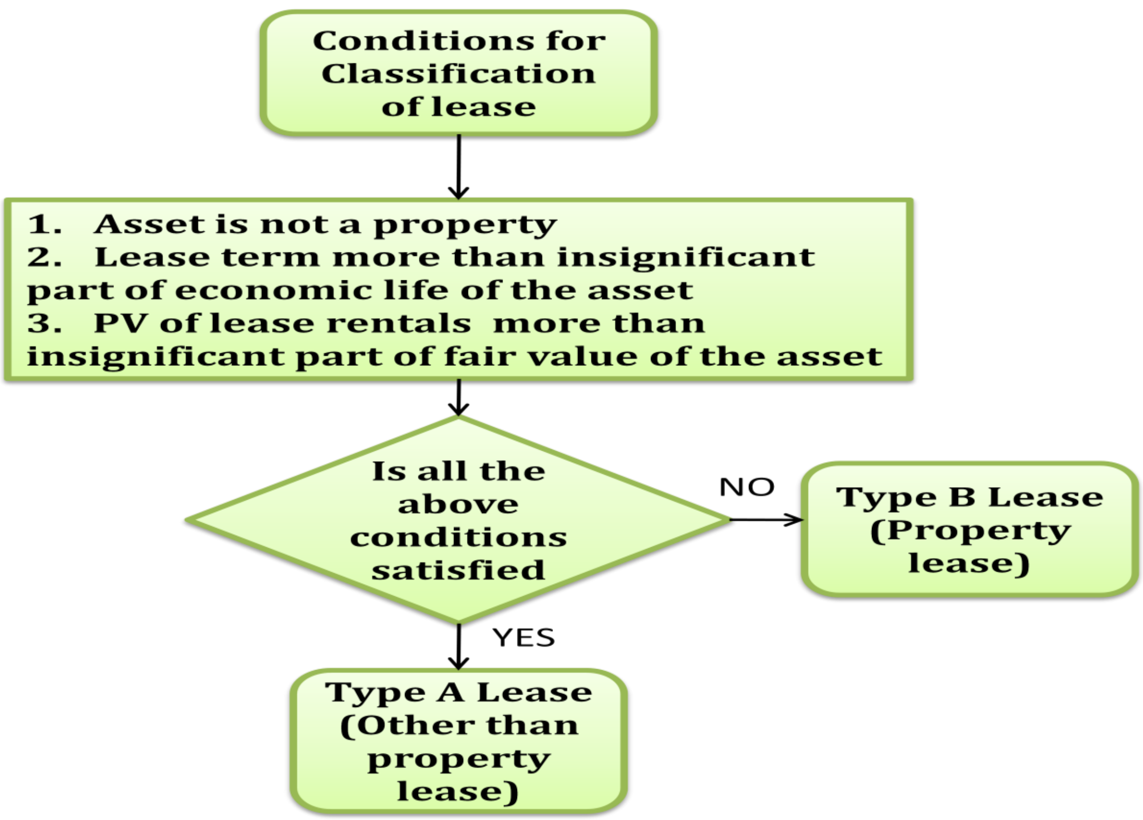
- Whereas for leases with a maximum possible term of 12 months or less, a lessee and a lessor have an option to make an accounting policy election which is similar to existing operating lease accounting and may not be required to recognize assets and liabilities.

Lease Term includes

- Non-cancellable lease period.
- Optional period to extend the lease if the lessee has a significant economic incentive to *exercise* that option.
- Optional period to terminate the lease if the lessee has a significant economic incentive of *not exercising* that option.

Classification of lease

Lease has to be classified either as Type A lease (lease of equipment or vehicles) or Type B lease (lease of property) based on fulfillment of certain conditions. The same has been depicted below:



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Type A Lease

In Type A lease, a lessee generally consumes a part of any equipment or vehicle that is taken on lease. Hence the lease is so priced by the lessor to recover the value of the part of the asset so consumed by the lessee along with a return on its investment in the asset. Thus a lease can be classified as Type A lease when ***all*** the three conditions are fulfilled:

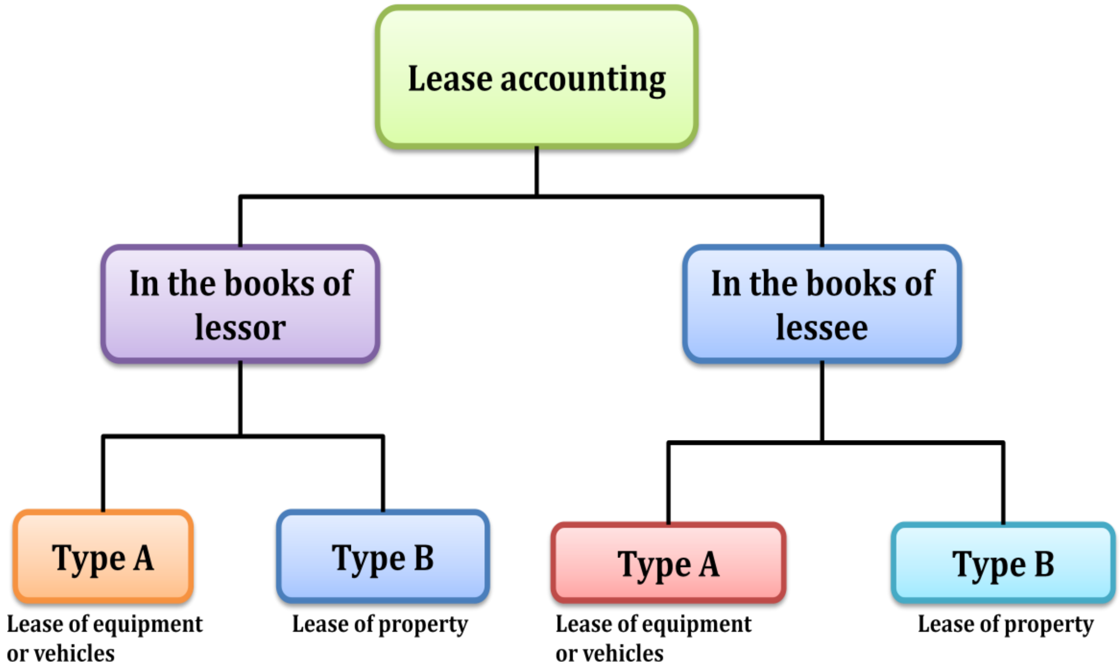
- The underlying asset is not property.
- The lease term is more than an insignificant part of the total economic life of the underlying asset.
- The present value of the lease payments is more than an insignificant part of the fair value of the underlying asset as on the lease commencement date.

Type B Lease

In Type B lease a lessee, does not consume more than an insignificant part of the asset, it merely uses the underlying asset. The reason behind this is that land has an indefinite life and its value would not be expected to be consumed by a lessee. Hence the lease is priced by the lessor so as to obtain a return on its investment in the underlying asset. Unlike the Type A lease no recovery of the value of part of asset so consumed is to be made. Thus a lease other than Type A lease can be classified as Type B lease. A type B when ***all*** the below mentioned conditions are satisfied:

- The underlying asset is a property.
- The lease term does not form a major part of the remaining economic life of the underlying asset.
- The present value of the lease payments does not account for *substantially all* of the fair value of the property.

Accounting for Leases



For leases with a maximum possible term of more than 12 months the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

- The accounting for existing operating leases of more than 12 months will significantly change.
- Although for all practical purposes, the accounting for finance leases would remain unchanged.
- Even under operating leases for the substantial majority of leases of equipment or vehicles, the balance sheet, income statement and cash flow statement would change
- Whereas for the substantial majority of leases of property only the balance sheet would change.

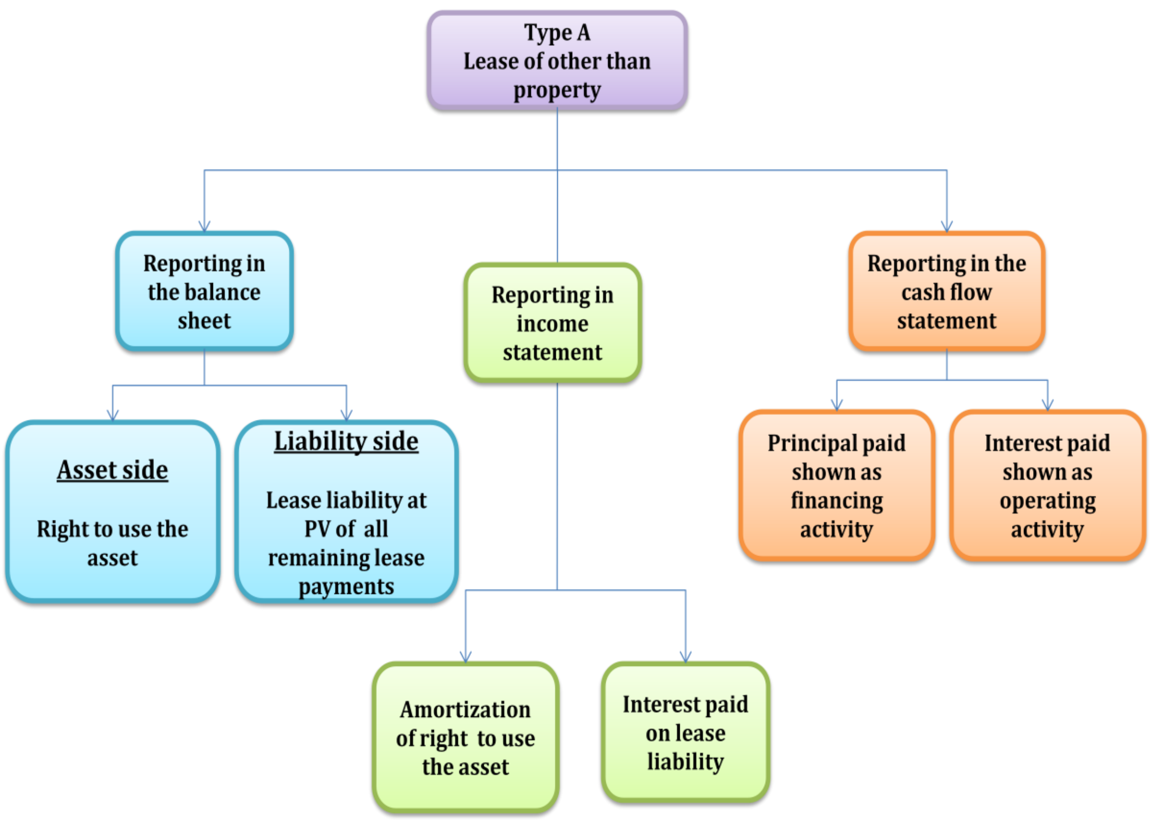
In the books of Lessee

The lessee would be liable to recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the leased asset (the underlying asset) for the lease term.

The recognition has been explained below for both Type A leases and Type B leases from the lessee's viewpoint.

Type A lease (lease of other than property)

In Type A lease the lessee is expected to consume more than an insignificant portion of the leased asset and in such case lease accounting would be similar to a finance lease in existing accounting standards. Majority of leases are Type A lease and for all such lease the accounting treatment shall be done as reflected hereunder.



Reporting in the Balance Sheet

The lessee shall make the following recognition in the balance sheet:

- At the time of commencement of lease: Initial lease recognition

  - The right-to-use asset, measured at the amount for which the right to use is acquired. It is the sum total of the present value of the remaining lease payments, any lease payment made at the date of commencement of lease and any direct initial cost incurred.

  - The lease liability, it is the liability for taking the asset on lease and is measured at the present value of all the remaining lease payments to be made.

- Year end reporting during the lease term

  - The right to use asset is amortized on straight line basis over the lease term and at the end of the year it is reported at the amortized value.

  - The interest is accrued on lease liability. Lease liability is reported including the accrued interest on the outstanding liability after adjusting the lease rentals paid.

Reporting in the income statement

The lessee recognizes lease expense every year throughout the lease term, in two separate parts: the unwinding of the discount on the lease liability as interest are shown separately from the amortization of the right-of-use asset.

- Recognition of amortization of the right to use the asset on straight line basis over the lease term.

- Recognition of interest paid or payable on the lease liability. Interest shall be calculated on the outstanding balance of lease liability, at the rate the lessor charges the lessee and if such rate is not available then at lessee's incremental borrowing rate.

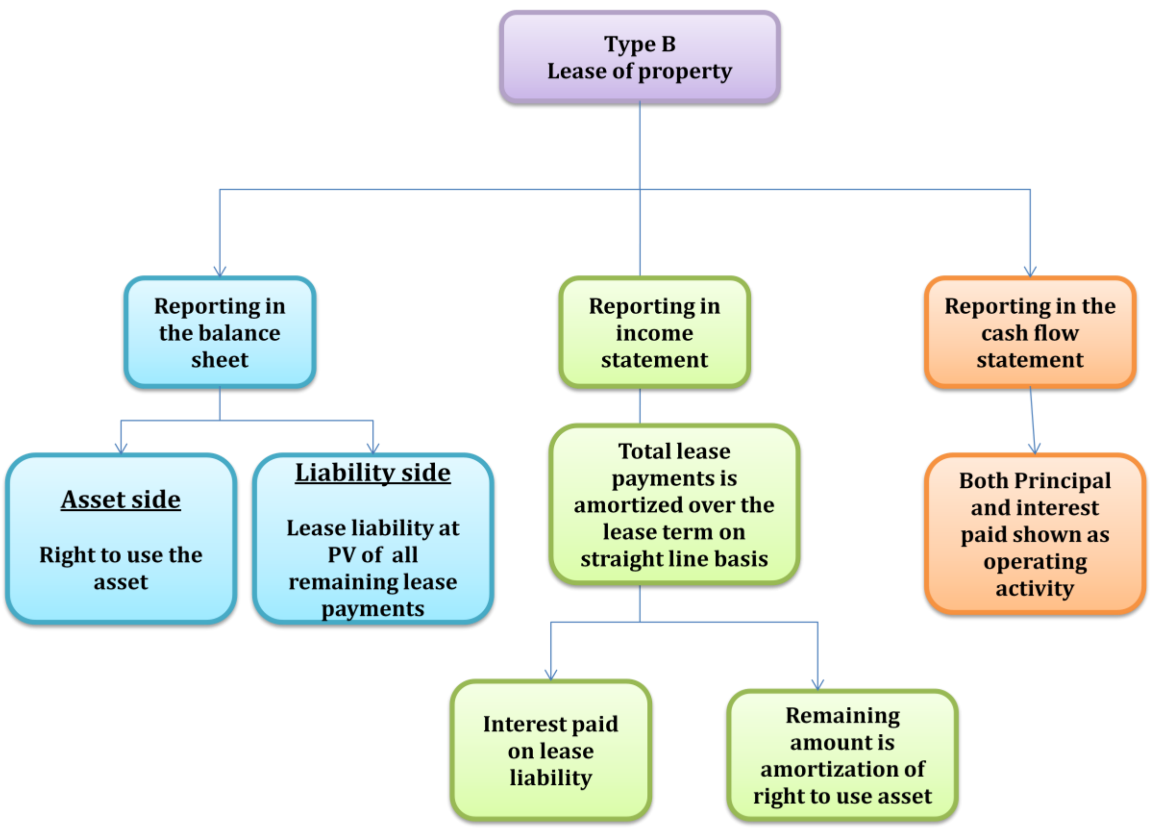
Reporting in the cash flow statement

The lessee will show separately the financing activity and the operating activity in the cash flow statement. The total amount of cash paid shall be segregated into a principal portion and the interest portion.

- The principal portion of lease liability repaid will be reflected as cash outflow from financing activity.
- The interest portion of the lease liability repaid will be reflected as cash outflow from operating activity.

Type B lease (lease of property)

In Type B lease the lessee is not expected to consume more than an insignificant portion of the leased asset and lessee is paying only for use of the leased asset. The lessee would account for the lease in the income statement and cash flow statement similarly to an operating lease in existing accounting standards.



Reporting in the Balance Sheet:

Reporting in balance sheet for Type B leases will be similar to that of Type A lease.

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- At the time of commencement of lease: Initial lease recognition

    - The right-to-use asset, measured at the amount for which the right to use is acquired. It is the sum total of the present value of the remaining lease payments, any lease payment made at the date of commencement of lease and any direct initial cost incurred.

    - The lease liability, it is the liability for taking the asset on lease and is measured at the present value of all the remaining lease payments to be made.

- Year end reporting during the lease term

    - The right to use asset is amortized on straight line basis over the lease term and at the end of the year it is reported at the amortized value.

    - The interest is accrued on lease liability. Lease liability is reported including the accrued interest on the outstanding liability after adjusting the lease rentals paid.

Reporting in the Income Statement:

Reporting in the income statement for Type B lease shall vary from that of Type A lease.

- The lessee shall report the lease expense on a straight-line basis in the income statement, over the lease term.

- Recognition of a single lease cost is made, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset.

    - The sum total of entire lease payments made by the lessee along with any initial direct costs incurred by the lessee shall be amortized over the lease term as annual lease expense.

    - It is to be noted that the entire lease payments are to be taken and not their present values.

    - This annual lease expense reflected as a single cost is actually comprising of two parts:

        - Firstly, the interest on the lease liability shall be computed. Interest shall be calculated on the outstanding balance of lease liability, at the rate the

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lessor charges the lessee and if such rate is not available then at lessee's incremental borrowing rate.

- Secondly, the remaining portion of the annual lease expense after deducting the interest element as calculated above shall reflect the amortization of right of use of asset.

Reporting in the cash flow statement

- The entire lease payment made by the lessee shall be shown as cash outflow from operating activity in the cash flow statement.

- No segregation of principal and interest portion is made and hence no classification under the operating and financing activity is required.

In the books of Lessor

Accounting treatment followed by a lessor would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. The lessor would distinguish between most property and most equipment leases in the same way that a lessee would under the proposals.

It would be beneficial to distinguish credit risk (the risk associated with receivables from lessees) from asset risk (risk associated with residual interests in underlying assets) thereby requiring a lessor to account for its residual interest in underlying assets separately from its receivables from lessees.

Type A lease (lease of other than property)

The draft has been so designed to overcome the difficulties faced by some of the users of financial statements due to the present lack of transparency in Lessor's exposure to credit risk and asset risk.

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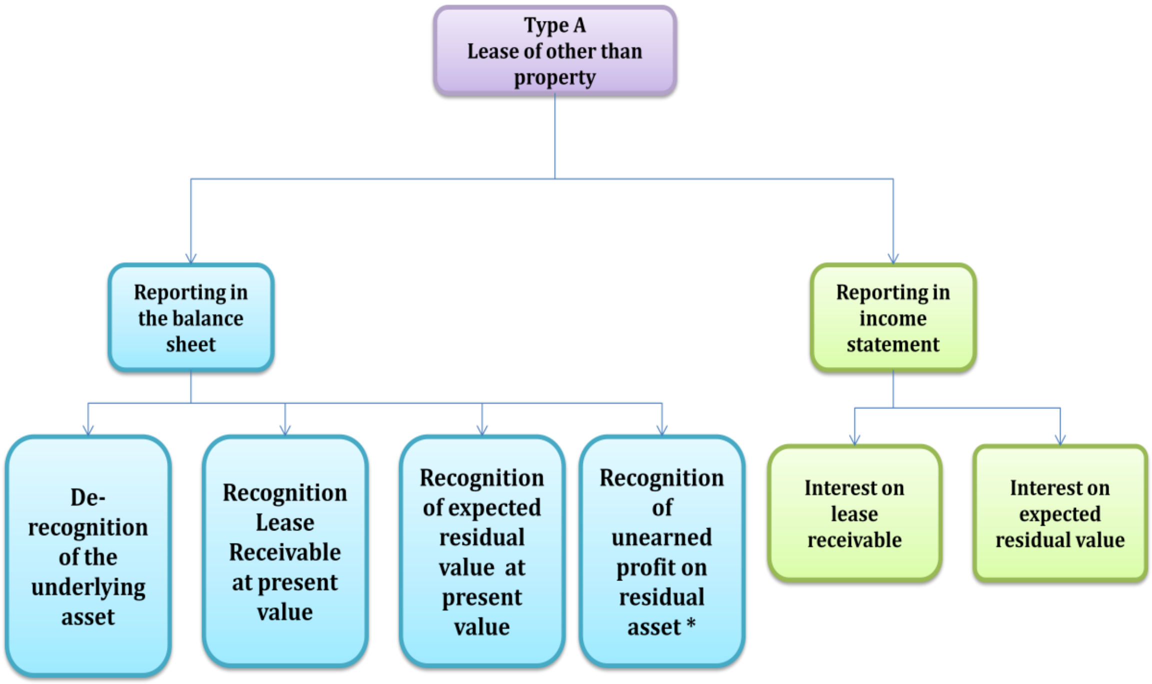

** Unearned profit on residual asset is recognized only when the carrying amount of the asset is lower than its fair value, at the time of commencement of lease.*

Reporting in the Balance Sheet:

At the commencement of lease, the lessor has to de-recognize the underlying asset (the equipment or vehicles) and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset). The reporting shall be as follows;

- De-recognize the underlying asset.
- Recognize lease receivables from the lessee. Lease receivable shall be recognized at the present value of the lease installments receivable from the lessee.
- Recognize the expected residual value of the asset at the end of the lease term. The gross residual value of the asset shall be the recorded at the present value of the estimated amount that the asset would fetch at the end of the lease term.
- The unearned profit on residual asset shall be recognized, only when the carrying amount of the asset is less than the fair value of the asset as on the commencement date..

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Reporting in the Income Statement:

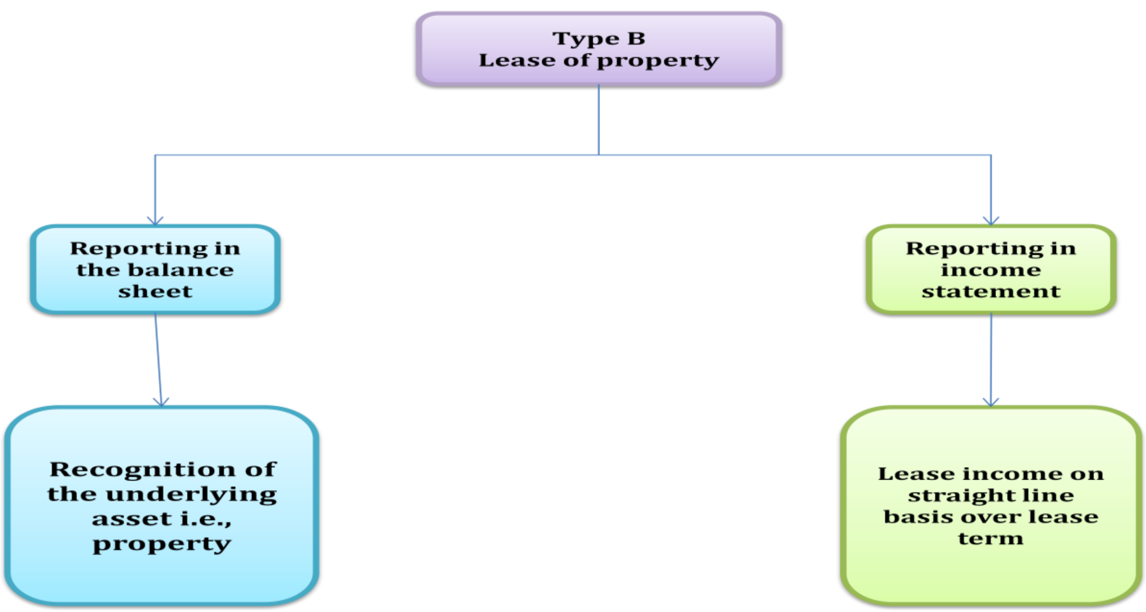
- In the income statement the lessor shall recognize an income of interest on lease receivable. The lease receivable comprises of principal component and the interest component. The interest on lease receivable shall be calculated at the imputed rate for the lease as applied on the balance of lease receivable.

- Lessor shall recognize interest income on the residual value of the asset.

- The lessor shall also recognize any profit relating to the lease at the commencement of the lease.

Type B lease (lease of property)

Many lessor of property view their leasing activities as an important component of their broader investment strategy. Leases are priced to earn a particular yield based on the fair value of the property and the lessor would often expect to also generate returns from capital appreciation of the property.



Reporting in the Balance Sheet

The lessor shall continue to recognize the underlying asset (the property) and no de-recognition of it is required further no receivables from the lessee shall be shown.

Reporting in the Income Statement

The lessor shall recognize the lease income over the lease term, typically on a straight-line basis. No segregation of the lease rentals is to be made by the lessor.

Type A leases are dealt mostly in the leasing industry hence an illustrative example on accounting of the same from both the lessor's and lessee's perspective has been illustrated below.

Case-I When carrying amount and fair value of the asset are same

Assumptions	
Carrying value/Fair value on inception	10000
Tenure of the lease (years)	3
Lease rentals per annum	2400
Residual value	4500

Calculations	
IRR of the lessor	6.87%
PV of lease receivables	6,313.29
PV of RV	3686.71
Total PV	10,000.00
Imputed rate in rentals	6.87%

In the books of Lessor

Year	PV of Lease Receivable (opening balance)	Interest accrued on Lease Receivable	Total Lease Receivable	Lease Rentals Received	PV of Lease Receivable (closing balance)	PV of expected residual value	Interest accrued on residual value	Total of expected residual value	Total amount credited to P&L
1	6,313	434	6,747	2,400	4,347	3,687	253	3,940	687
2	4,347	299	4,646	2,400	2,246	3,940	271	4,211	569
3	2,246	154	2,400	2,400	0	4,211	289	4,500	444

In the books of the lessee

Year	Right to use the asset (Opening Balance)	Amortization of right to use	Right to use the asset (Closing Balance)	PV of Lease Payables (opening balance)	Interest on Lease Payable	Total Lease Payable	Lease Rentals Paid	PV of Lease Payable (closing balance)	Total amount debited to P&L
1	6,313	2,104	4,209	6,313	434	6,747	2,400	4,347	2,538
2	4,209	2,104	2,104	4,347	299	4,646	2,400	2,246	2,403
3	2,104	2,104	0	2,246	154	2,400	2,400	0	2,259

Journal Entries

In the books of the Lessor

	At the time of inception		At the end of year 1		At the end of year 2		At the end of year 3	
Particulars	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)
At the time of inception of lease								
Lease Receivable	6,313							
Residual Asset	3,687							
To Underlying Asset		10,000						
Year end entries								
Cash/ Bank			2,400		2,400		2,400	
To Lease Receivable				2,400		2,400		2,400
Lease Receivable			434		299		154	
Residual Asset			253		271		289	
To Interest on lease receivable				434		299		154
To Interest on residual value				253		271		289

In the books of the Lessee

	At the time of inception		At the end of year 1		At the end of year 2		At the end of year 3	
Particulars	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)
At the time of inception of lease								

Right to use the asset	6,313							
To Lease Liability		6,313						
Year end entries								
Lease Liability			2,400		2,400		2,400	
To Cash/ Bank				2,400		2,400		2,400
Interest on lease liabilty			434		299		154	
Amortization of right to use			2,104		2,104		2,104	
To Lease Liability				434		299		154
To Right to use the asset				2,104		2,104		2,104

Case-II When carrying amount of the asset is lower than its fair value

Assumptions	
Carrying value of the asset	7500
Fair value of the asset	10000
Tenure of the lease (in years)	3
Lease rentals per annum	2400
Residual value	4500

Calculations	
IRR of the lessor	6.871%
PV of lease receivables	6,313
PV of RV	3,687
Total PV	10,000
Portion of profit to be recognised	1,578
Portion of unearned profit in RV	922
Imputed rate in rentals	6.87%

In the books of Lessor

Year	PV of Lease Receivable (opening balance)	Interest accrued on Lease Receivable	Total Lease Receivable	Lease Rentals Received	PV of Lease Receivable (closing balance)	PV of expected residual value	Interest accrued on residual value	Total of expected residual value	Profit in RV recognised upfront	Unearned profit in RV	Total amount credited to P&L

1	6,313	434	6,747	2,400	4,347	3,687	253	3,940	1,578	922	2,265
2	4,347	299	4,646	2,400	2,246	3,940	271	4,211		0	569
3	2,246	154	2,400	2,400	0	4,211	289	4,500		0	444

<u>In the books of the Lessee</u>

Year	Right to use the asset (Opening Balance)	Amortization of right to use	Right to use the asset (Closing Balance)	PV of Lease Payables (opening balance)	Interest on Lease Payable	Total Lease Payable	Lease Rentals Paid	PV of Lease Payable (closing balance)	Total amount debited to P&L
1	6,313	2,104	4,209	6,313	434	6,747	2,400	4,347	2,538
2	4,209	2,104	2,104	4,347	299	4,646	2,400	2,246	2,403
3	2,104	2,104	0	2,246	154	2,400	2,400	0	2,259

<u>Journal Entries</u>

In the books of the Lessor

	At the time of inception		At the end of year 1		At the end of year 2		At the end of year 3	
Particulars	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)	Amount (Debit)	Amount (Credit)
At the time of inception of lease								
Lease Receivable	6,313							
Gross Residual Asset	3,687							
To Profit in RV recognized upfront		1,578						
To Unearned profit on residual value		922						
To Underlying Asset		7,500						
Year end entries								
Cash/ Bank			2,400		2,400		2,400	
To Lease Receivable				2,400		2,400		2,400
Lease Receivable			434		299		154	
Residual Asset			253		271		289	
To Interest on lease receivable				434		299		154
To Interest on residual value				253		271		289

In the books of the Lessee

Particulars	At the time of inception Amount (Debit)	At the time of inception Amount (Credit)	At the end of year 1 Amount (Debit)	At the end of year 1 Amount (Credit)	At the end of year 2 Amount (Debit)	At the end of year 2 Amount (Credit)	At the end of year 3 Amount (Debit)	At the end of year 3 Amount (Credit)
At the time of inception of lease								
Right to use the asset	6,313							
To Lease Liability		6,313						
Year end entries								
Lease Liability			2,400		2,400		2,400	
To Cash/ Bank				2,400		2,400		2,400
Interest on lease liabilty			434		299		154	
Amortization of right to use			2,104		2,104		2,104	
To Lease Liability				434		299		154
To Right to use the asset				2,104		2,104		2,104

Conclusion

The revised Exposure Draft has shaken the entire industry. The industry that had since decades, classified leases as financial and operating lease will now have to shift to Type A lease and Type B lease. Further the compulsion of bringing all types of leases on balance sheet except for short term lease, has raised a huge question towards the industry's next course of action. *Will now the industry be forced to limit their lease term to twelve months for availing the off balance sheet benefit?* The question still remains unanswered.

The proposal is still under draft form and is awaiting feedback till September 13, 2013. This is now a buzzing issue for the entire lease industry and everyone is awaiting the final standard on leases that the IASB and FASB will come up with after considering the feedback on the exposure draft. It's high time for the leasing industry, to pull up its socks on how to adapt and combat with the huge changes being proposed.