

Note on the Discussion Paper on Lease Accounting

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The Accounting Standards for leases has been under constant review for sometime now. There have been discussions on adopting a new approach in accounting, which will not distinguish leases based on Financial and Operating Lease but disclosures to be made on the basis of 'right to use' asset and 'obligation to pay rentals' liabilities. The 'right to use' and an 'obligation to pay rentals' means a right or an obligation arising out of a past event resulting in inflow and outflow of economic benefits respectively.

In this regard, International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (referred to as "Boards" hereon) came together to develop lease accounting standards and came out with a Discussion Paper in March, 2009 – *Leases: Preliminary Views*. The Discussion Paper brings in a sea change in the way leases have been dealt with so far, this article hereby covers the key features of the Discussion Paper and analytically reviews the outcomes of the changes, if implemented.

Why the need for the Discussion Paper:

As per the present Accounting Standard IAS – 17, in a financial lease the asset and liabilities are recognized on the books of the lessee and the lease is more of a funding or financing transaction. On the other hand in case of operating lease (leases other than finance lease as defined in the accounting standard) the asset is not recognized in the books of the lessee. As per the World Leasing Yearbook, 2009 – in 2007 the annual volumes of the leases amounted to US\$ 760 billion; however the assets and the liabilities arising from these contracts were not reflected in the entities' financial position. So, the intent of the parties in a lease contract is to document the transaction in a manner so that it is in the form of an operating lease. To deal with this, Discussion Paper reviews the present accounting standards, after which the operating leases may not be an off-balance sheet transaction.

This was in response to the concern raised by investors, financial statement analysts as the off-balance sheet treatment made it difficult for them to get a true view of the financial status.

Highlights of the Discussion Paper

The Discussion Paper includes recognition and measurement of assets and liabilities arising in a leasing contract, accounting for options in a lease transaction, accounting for residual value, contingent rentals and how they would appear in a financial statement.

- Earlier the recognition or classification of leases was on basis of transfer of risks and rewards associated with the asset, whereas the Discussion Paper intends to

shift the focus from this concept and lays down that presentation on the financial statement should be on the basis of asset and liabilities generated. So the idea is to create a common standard on lease accounting for all types of leases.

- The lessee's obligation would not only include the rentals payable to be recognized but would also include the contingent rentals and residual value guarantees.
- The lessee need not recognize the options available at the end of the lease term as a separate asset. If at the inception, for instance, it is likely that the lessee will renew the lease then the obligation is to be considered including the renewal leasing period.
- The Discussion Paper dodges the complexities of a lease transaction which in commercial parlance is a little impractical.
- There is no improvisation on the lessor's accounting in a lease transaction, there are only options discussed for review, which we will now talk about.

Discussion Paper on accounting for the lessor: The Discussion Paper does not consider the lessor's accounting and only weighs possibilities of changes that could be incorporated. The Discussion Paper in length deals with developing a model for improving on lessee's accounting only.

The two recommendations considered for lessor's accounting treatment are:

- Transfer of a portion of liability – The asset side will show the lease receivables and the residual value in the books and no liability recognized
- Creating a new right – The asset side would continue to show the leased asset in the books and lease receivables. The liability side would recognize the performance obligation (equivalent to lease receivables)

Initial recognition from lessee's perspective: In the initial measurement the following were recommended by the Boards:

- The Boards noted that in most leases the present value of the lease payments discounted using the lessee's incremental borrowing rate would be a reasonable approximation to fair value.
- The right-of-use asset is to be recorded 'at cost' consistent with the measurement of other non-financial assets at cost; facilitating easier comparison. The initial measurement at cost meant present value of lease rentals discounted with the incremental cost of borrowing.

Subsequent recognition from lessee's perspective: In the subsequent recognition the Boards considered two approaches for subsequent measurement of the obligation to pay the rentals a) fair value approach b) amortized cost based approach. The fair value method was inconsistent with the Boards' decision to have lease rentals at cost and subsequent remeasurement of the rentals based on the fair value would make it complex, costly and impracticable. The amortised cost based approach was preferred by the

Boards, which meant that the interest would accrue on the outstanding obligation to pay rentals.

In case of changes in the lease transaction, for instance purchase option, extending/ termination of lease are applied; the accounting treatment would change accordingly. The Boards recommended a catch-up approach that would be applicable; here the carrying amount of the liability is adjusted to the present value of the revised estimated cash flows, discounted at the original effective interest rate.

Basis for amortization of lease rentals: This amortization is based on ‘consumption of economic benefit’ of the asset. For instance, if the lessee is to obtain the title of the asset at the end of the lease period, amortization is to be done over the economic life of the asset. At the inception of the lease transaction if the lessee is likely to exercise the purchase option the obligation to pay the rentals will include the exercise price of option.

Calculation of lease rentals for multiple options available to the lessee: The lessee has several options available in a lease transaction – a) renewal option, b) returning the asset and c) purchase option. The lease rentals will also be determined differently in each case. For example, a lease is for 10 years and there is a renewal option period of another 5 years. In case there are three options (as illustrated in the example) available to the lessee at the end of the primary lease period, the option that the lessee is likely to exercise will determine the obligation of the lessee and calculation of the lease rentals payable. The following is how the lease rentals shall be calculated:

<u>Option</u>	<u>lease rentals</u>
1) renew lease	10+5 years
2) return asset	10 years
3) purchase option	10+ purchase price**

** Purchase price can be – 1) Fair value price, 2) Fixed price and 3) Bargain price

How the recommended approach differs from the existing approach: The recommendations by the Boards if implied will bring a sea change in the way lease accounting is carried out. The most apparent being the following:

- 1) The difference is financial leases and operating leases would not exist. The basis for accounting would be right-of-use asset and obligation to pay rentals liability. This would mean going by the ‘asset’ definition reviewed by the two Boards under the joint conceptual framework project, December 2006, if any lease qualifies as an asset it is to be capitalized in the books, irrespective the lease it qualifies as. Thus the operating lease transaction would not be off-balance sheet anymore.

- 2) The Boards' decision to reflect the lease rentals in the books at cost may not be presenting the true value of the right and obligation as the fair value adjustments are not made.
- 3) The existing standard for calculation of lease rentals uses implicit rate of return. In the recommended approach lessee's incremental cost of borrowing is to be used for arriving at the fair value of rentals.
- 4) There would be no reassessment of the incremental borrowing rate as per the recommended approach; however any alteration in the lease agreement would be adjusted as per the catch-up approach. The existing approach considers the implicit rate of return or IRR method whereby any revision interest rate is adjusted with the rentals from retrospective effect and adjusted accordingly.
- 5) **Contingent rentals:** The two Boards are divided on their approach on determining the contingent rentals. IASB adopts the 'probability weightage' approach and FASB adopts the 'most likely' approach. The Boards however recommends that contingent rentals should be recognized as asset. It should also be recognized as a liability as paying is unconditional though the amount may not be certain. The existing approach of accounting the contingent rentals recognizes it as an expense in the period of occurrence.
- 6) **Residual value:** As per the recommendation the treatment will be the same as in case of contingent rentals. On the other hand the existing approach includes residual value in the lease rentals.
- 7) The Boards approach towards complex lease agreements is unclear. Where the Boards identify only a single right-of-use asset which would include rights acquired under the various options (options to buy the asset, renew the lease term etc) and a single obligation to pay including the contingent rentals and residual guarantee. In the existing approach there are clear cut provisions for capitalizing and/ or showing income/ expenditure in the profit & loss account.

Accounting treatment for the lessee:

	Particulars	Accounting head	Remarks
1.	Obligation to pay rentals	liability	
2.	Right-of-use of asset	asset	Presented as asset with distinction on owned and leased assets. IASB and FASB vary on accounting treatment.
3.	Reduction in value of asset	Depreciation Amortisation	In case presented as 'other assets' In case presented as 'intangible assets'
4.	Interest expense	expense	Include in general expense or show separately in the income statement.