



CHARTERED CERTIFIED ACCOUNTANTS

Article topic: Financial Reporting

The Future of Accounting for Leases

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Lease accounting has always presented problems within the accountancy profession because of the way certain leases are accounted for in an entity's profit and loss account (income statement) and/or balance sheet (statement of financial position). The main problem with lease accounting is the ability to manipulate the financial statements by incorrectly classifying 'finance' leases as 'operating leases' resulting in off balance sheet finance.

SSAP 21 'Accounting for Leases and Hire Purchase Contracts' and IAS 17 'Leases' deal with the accounting issues from the perspective of the lessee and the lessor.

Current Accounting Requirements

Operating Leases

Payments under an operating lease are charged to the profit and loss account (income statement) on a straight-line basis over the lease term, unless another systematic basis is more appropriate.

Classification of operating leases depends on whether the 'risks and rewards' of ownership of the asset(s) under the lease terms have substantially passed to the lessee. If the risks and rewards of ownership remain with the lessor, then the asset is accounted for as an operating lease. SSAP 21 simply defines an operating lease as '*a lease other than a finance lease*'.

Finance Leases

Finance leases are accounted for as such when substantially all the risks and rewards of ownership are passed to the lessee. IAS 17 contains guidance when substantially all the risks and rewards of ownership are passed to the lessee:

- The lease transfers ownership to the lessee at the end of the lease term.
- There is a bargain purchase option at the end of the lease term.
- The lease term is for the major part of the asset's useful life.
- The present value (at the inception of the lease) of the minimum lease payment is at least equal to substantially all of the fair value of the leased asset, net of grants and tax credits to the lessor at that time (title may or may not eventually pass to the lessee).
- The leased assets are of such a specialised nature that only the lessee can use them without modifications being made.
- Cancellation costs are to be borne by the lessee if the lease is cancelled before the end of its term.
- Gains or losses arising from the fluctuation of fair value of the residual amount will accrue to the lessee.

- The lessee has the ability to continue the lease for a supplemental term at a rent that is substantially lower than market rent (a 'peppercorn' rent).

SSAP 21 has a well-known 90% test. In contrast, IAS 17 does not contain such a benchmark.

The Proposals

The introduction of accounting standards in the area of lease accounting were brought in with the intention of mitigating the concept of 'off balance sheet finance'. However, according to the International Accounting Standards Board (IASB) the World Leasing Year Book 2009, cited an amount of \$760 billion in leases in 2007. The problem of off balance sheet finance is still prevalent because many leased assets and associated liabilities cannot be found on entities statements of financial position (balance sheet).

The IASB and the US standard-setters (the Financial Accounting Standards Board (FASB)) have joined together to develop a revised standard that will deal with lease accounting. The IASB and FASB have identified a number of problems with the current standards, such as:

- Users complain that the financial statements do not depict clearly the effects of operating leases.
- Similar transactions can be accounted for very differently (due to the split between finance and operating leases).
- The standards provide opportunities to structure transactions in such a way to achieve a particular lease classification

In analysing lease contracts, the IASB and FASB have concluded that, regardless of whether a lease is classified as an operating lease, lease contracts will always create rights and obligations that meet the IASB and FASB definition of assets and liabilities. As such, the proposal is that all leases will be treated and accounted for as finance leases. The fact that substantially all risks and rewards might remain with the lessor are essentially redundant by virtue of the fact that an obligation is created on the part of the lessee to pay rentals for the rights to use the asset which is subject to the lease.

The discussion paper also cites the Board's proposals for those leases which are more complex than traditional leases, such as those which contain options to renew or terminate the lease contract, options to purchase the leased item, contingent rental arrangements or residual value guarantees.

The discussion papers confirm that the Board will not require lessees to recognise the renewal, termination or purchase options separately. Instead, the lessee should determine whether the option will be exercised. If exercising the option is the most likely outcome, then the lessee will account for it. The Board have also confirmed that obligations to pay rentals should include amounts payable under contingent rental arrangements and residual value guarantees.

The Next Step

The closing date for comments to be received closed in July 2009. An Exposure Draft is due to be issued by the IASB in quarter 3 of this year with a final standard to be issued in the second quarter of 2011.

Conclusion

Leasing has always been a controversial area within the profession and it is likely to affect a significant number of companies in the UK (especially as UK GAAP, in its current form, is often converged to IFRS). Gearing ratios will be affected, and this could be a cause for concern for those clients who have borrowing covenants with various banks and other financial institutions. The IASB and FASB are of the opinion that the new proposal will bring greater transparency to the financial statements.

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