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Content:

1. Leases- the new approach- Katarzyna Gierusz

The article summarizes the major idea of the new approach to leases- one accounting treatment for both finance and operating lease contract in lessees' accounts. The project was prepared jointly by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to ensure the common standard on lease accounting. The article is based on discussion paper which was open for public comment until 17th July 2009.



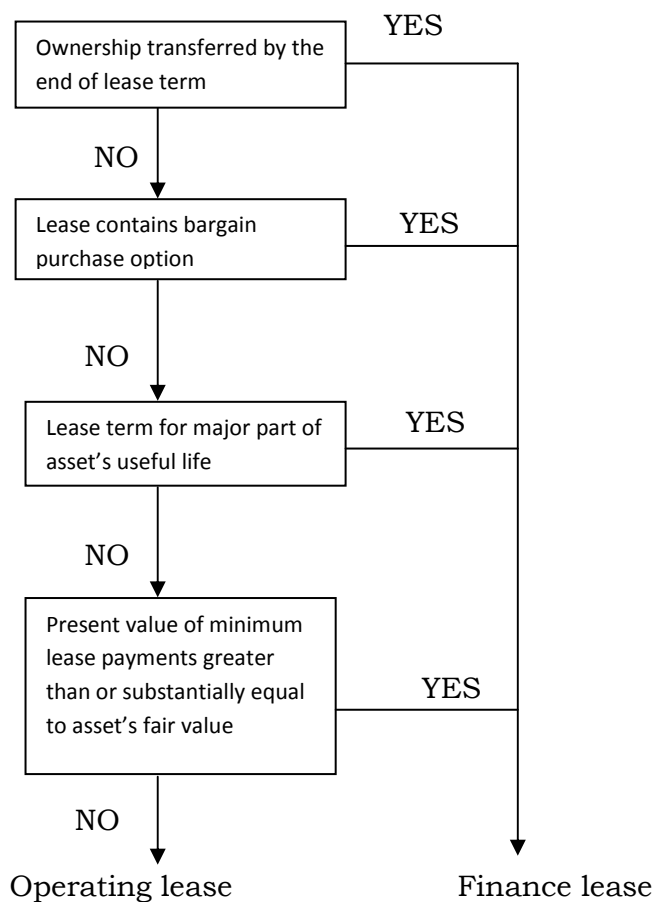
Leases- the new approach.

According to International Accounting Standard 17 Leases (IAS 17) *a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.* Two types of lease are distinguished:

- finance- a lease that transfer substantially all the risks and rewards of ownership of an asset. Title may or may not eventually be transferred;
- operating- a lease other than a finance lease.

The difference between finance and operating lease is shown in Figure 1.

Figure 1. Categorising of finance and operating leases.



Source: B. Elliott, J. Elliot, p. 439



At present, two different accounting treatments are recommended depending on category. The standard requires finance lease to be capitalized in the lessee's accounts. In consequence the leased item is presented as an asset while the obligation for future payment is recorded as a liability in the balance sheet. In the case of operating lease, the annual payments are treated as an expense and shown in the income statement.

This split is a reason of many problems such as¹:

- the assets and liabilities arising from many of contracts are not recognized in entities' statements;
- the economically similar transactions are accounted in a different way;
- opportunities to obtain a source of off balance sheet financing.

Those hitches reduce transparency and comparability of financial statements. To ensure complete and understandable picture of entities the boards have suggested the new approach based on the assumption that all lease contracts create rights and obligations that meet the definitions of assets and liabilities.

To epitomize this issue the boards analysed the following example²:

A machine is leased for a fixed term of five years. The expected life is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the item at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machine has been delivered. These are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

Although this is an obvious example of operating lease (according to existing approach) there is no doubt whatsoever that basic rights and obligations arise.

The Table 1 summarises the lessee rights and obligations identified by the boards

¹ Snapshot: leases- Preliminary Views; p. 2

² Leases- Preliminary Views; p. 24- 32



Table 1. Lessee rights and obligations identified by the boards.

Lessee rights	Lessee obligations
<ul style="list-style-type: none"> right to use the machine for the lease term 	<ul style="list-style-type: none"> obligation to pay rentals
	<ul style="list-style-type: none"> obligation to return the machine at the end of the lease term

In next step, the boards analysed whether the above categories meet the definition of an asset and liability. The result was positive and is presented in Table 2.

Table 2. Identification of assets and liabilities arising in lease contract.

Description of right	Control	Past event	Future economic benefits?	Asset?
Right to use machine during the lease term	Legally enforceable right established by the lease contract	Delivery following signing of the lease contract	Yes	Yes
Description of obligation	Present obligation	Past event	Outflow of economic benefits?	Liability?
Obligation to pay rentals	Legally enforceable obligation established by lease contract	Delivery following signing of the lease contract	Yes (cash payments)	Yes
Obligation to return the machine at the end of the lease term	Legally enforceable obligation established by the lease contract	Delivery following signing of the lease contract	No, because the lessee has no right to economic benefits from the machine and will not have to make any payments after the end of the lease term	No



The above study shows that finance lease can no longer be treated as purchase of the leased item while operating lease as executory contract. Thus, a new approach to accounting for leases has been suggested by the boards. According to it all lease contracts are acquisition of a right to use the leased item for the lease term. Therefore, the lessee should recognize the following:

- an asset representing its right to use the leased item for the lease term;
- a liability for its obligation to pay rentals.

The “new” standard solves the main problem connected with existing one, namely, the potential for framing a finance lease as an operating lease and not having to capitalize the lease contract on lessee’s balance sheet. Moreover, the new approach is consistence with the boards’ conceptual frameworks and recently issued standards. On the other hand, some new obstacles arise such as valuation. Furthermore, there is no doubt that finance industry will invent new types of financial agreements to escape the leasing standard³.

The Preliminary Views cover more issues; however, they are not topic of this article.

As soon as the boards collect all feedbacks on their proposals, the exposure draft will be developed. It is planned for 2010.

³ B. Elliott, J. Elliot, p. 447



References:

1. Elliott B., Elliott J.; *Financial Accounting and Reporting 12th edition*; Pearson edition published 2008.
2. IASB, FASB; *Leases- Preliminary Views*, March 2009.
3. Snapshot: leases- Preliminary Views, www.iasb.org