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University of Economics, Prague

Faculty of Finance and Accounting

Department of Financial Accounting and Auditing



Leases



EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
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MINISTERSTVO ŠKOLSTVÍ,
MLÁDEŽE A TĚLOVÝCHOVY

1FU59x Intermediate Accounting: Presentation

1 Basic characteristics of leases

- A lease is method how to obtain an asset to use it for a fee
- A lease is defined as an agreement whereby the lessor conveys to the lessee in return for a payment(s) the right to use an asset for an agreed period of time
- Classification of leases:
 - a financial lease that transfers substantially all the risks and rewards incidental to ownership of an asset
 - an operating lease is a lease other than a finance lease
- A financial lease is an example, when economic substance may differ from legal form:
 - legal title is held by the lessor

- commercial benefits from usage the asset over its all (or almost all) useful life belong to the lessee
- substance over form principle requires recognising of an asset on the lessee's balance sheet together with corresponding finance liability

Finance lease

Substantially all risk and rewards transferred to lessee

Lessee recognises asset and liability

Lessor derecognises asset and recognises receivable

Operating lease

Substantial risk and rewards remain by lessor

Lessee recognises lease expense on straight-line basis

Lessor continues to recognised leased asset as non-current asset

2 Classification of leases

- Indicators (individually or combined) of transfer of risks and rewards and thus of finance lease occurrence:
 - the lease transfers ownership of the asset to the lessee by the end of the lease term
 - the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised
 - the lease term is for the major part of the economic life of the asset even if title is not transferred
 - at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset

- the leased assets are of such a specialised nature that only the lessee can use them without major modifications
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
- gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent
- Indicators above are not always conclusive, a judgement is needed

Risks

- Repairs and maintenance are made by lessee
- Insurance is borne by lessee
- Risk or idle capacity losses
- Technological obsolescence risk of the asset affects the lessee

Rewards

- Lessee has right to use asset for most or all its useful life
- Lessee has right option to buy an asset for a price, for which may obtain excessive gain on immediate resale

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3 Accounting for operating leases under IAS 17

3.1 Lessee

- Risks remain at the lessor, therefore a lessee does not obtain a control over an asset
- Main principles of accounting treatment:
 - no asset recognised on the balance sheet
 - total liability (commitment) from operating lease only disclosed in the notes, but not presented on the balance sheet
 - rentals are charged to P&L on a straight-line basis over lease period (unless another systematic and rational basis reflects the agreement in a better way)
 - any differences between actual payments and straight-line expense charges are treated as accruals or prepayments

3.2 Lessor

- Lessor holds all significant risks and rewards related to the asset
- Main principles of accounting treatment:
 - asset is recognised on the lessor's balance sheet as non-current asset (or investment property)
 - asset is depreciated (if tangible), amortised (if intangible), or revaluated to fair value (if investment property)
 - rentals under operating leases are recognised as income in P&L on a straight-line basis over lease period (unless another systematic and rational basis reflects the agreement in a better way)
 - any differences between actual payments and straight-line income are treated as

receivable or deferred income

Operating lease by lessee

- No asset
- No liability
- No depreciation in P&L
- Rental expense on straight-line basis in P&L

Operating lease by lessor

- Asset remains at BS
- Asset is depreciated (or revaluated)
- Rental income on straight-line basis in P&L

4 Accounting for finance leases under IAS 17

4.1 Lessee

- The substance of finance lease to acquire asset => lessee obtains control over the asset
- Finance lease is an alternative financing tool to bank loan
- Main principles of accounting treatment:
 - non-current asset recognised together with full finance lease liability (divided into non-current and current portion)
 - the asset acquired is depreciated/amortised as required by IAS 16/IAS 38 (or revaluated according to IAS 40, if investment property has been purchased via finance lease)
 - lease payments are allocated into redemption of collateral and finance expense

- Depreciation of the asset over:
 - its useful life
 - the lease term, if shorter than useful life and the entity does not expect continuing usage after the end of lease term
- Initial measurement of the asset and liability at lower of:
 - fair value of the asset
 - present value of the lease payments (discounted at implicit interest rate or incremental borrowing rate)
- The initial measurement of the asset is increased by costs directly attributable to the acquisition as defined by IAS 16/ IAS 38

4.2 Lessor

- Lessor loses control over an asset by transferring risks and rewards
- Main principles of accounting treatment
 - the asset must be derecognised
 - an lease receivable is recognised instead of asset (net investment in the lease)
 - cash receipts are allocated into repayment of the lease receivable and finance income

Finance lease by lessee

- Non-current asset recognised
- Liability recognised
- Depreciation charges
- Interest expenses

Finance lease by lessor

- Asset derecognised
- Lease receivable recognised
- Interest income

5 Accounting for leases under IFRS 16

- Because of accounting treatment, operating leases were commonly utilised by companies as off-balance sheet financing ⇔ neither assets, nor liabilities shown on balance sheet → better picture of performance and indebtedness
- IASB and FASB decided to change the accounting model of leases by lessees
- All contracts meeting the lease test shall be presented in the same way by a lessee
- However, lessor's accounting remains unchanged

- Consequences of new guidance:
 - asymmetry in presentation by lessor and lessee
 - new items on balance sheet and change in structure of income statement and cash flow statement by lessee

5.1 Accounting for leases by lessee

- A contract contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration
- At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability
- At the commencement date, a lessee shall measure the right-of-use asset at cost, which comprises of:
 - the amount of the initial measurement of the lease liability
 - any lease payments made at or before the commencement date, less any lease incentives received
 - any initial direct costs incurred by the lessee

- an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories (see link to IAS 16)
- At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date:
 - the lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined; if that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate
 - the lease payments include fixed payments less any lease incentives receivable; variable lease payments that depend on an index or a rate; amounts expected to be payable by the lessee under residual value guarantees; the exercise price of a purchase

option if the lessee is reasonably certain to exercise that option; and payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

- Subsequent measurement after the commencement date:
 - a lessee shall measure the right-of-use asset applying a cost model, unless it applies fair value model under IAS 40 or revaluation model under IAS 16
 - a lessee shall measure the lease liability by increasing the carrying amount to reflect interest on the lease liability; reducing the carrying amount to reflect the lease payments made; and remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments

- Presentation:
 - a lessee shall either present in the statement of financial position, or disclose in the notes right-of-use assets separately from other assets as well as present or disclose lease liabilities separately from other liabilities
 - if a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and disclose which line items in the statement of financial position include those right-of-use assets

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FV model IAS 40

- RoU meets the definition of an investment property
- Compulsory application of IAS 40 fair value model

FV model IAS 16

- RoU meets the definition of PPE, for which an alternative revaluation model is applied
- IFRS 16 enables (not mandates) an entity to opt the revaluation model for a such RoU

Cost model IAS 16

- Other cases

