LEASE - OPERATING OR FINANCE?

This article is relevant to Papers F7 and P2

Complex lease terms mean that it is often difficult to determine how they should be classified. This article examines IAS 17 and sheds some light on the matter

Leases are classified currently under IAS 17, *Leases*, as finance or operating leases at inception, depending on whether substantially all the risks and rewards of ownership transfer to the lessee. Under a finance lease, the lessee has substantially all of the risks and reward of ownership. Situations that would normally lead to a lease being classified as a finance lease include the following:

- the lease transfers ownership of the asset to the lessee by the end of the lease term
- 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 a specialised nature such that only the lessee can use them without major modifications being made
- if the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
- gains or losses from fluctuations in the fair value of the residual fall to the lessee
- the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent

All other leases are operating leases.

The lease classification is made at the inception of the lease but a lessee and lessor may agree to change the provisions of the lease. However, changes in estimates for example, changes in the residual value of a leased property, or changes in circumstances such as default by the lessee, do not give rise to a new classification of a lease. If the changes would have resulted in a different lease classification, had they been applied originally, then the revised lease agreement is treated as a new lease over the remaining lease term. The original accounting entries are not retrospectively amended.

Often lease indicators may not always point in the same direction causing lease classification to be difficult. Leases of specialised assets will usually be structured as finance leases. If an asset is specialised, then this implies that no other entity has a use for the asset. Consequently the lessor will only achieve its return on investment through the lease payments and it will structure the lease as a finance lease accordingly. If a lessor can sell or lease non-specialised assets to other parties at the end of the lease and is willing to accept the financial risk on this then this could be an indicator of an operating lease. Assets of a non-specialised may become specialised. For example, leased plant and equipment may be permanently installed in a building and its removal at the end of the lease may be impractical or too expensive for the lessor. Often specialised assets may have a significant remaining life at the end of the lease and sometimes this remaining life may be the major part of the economic life of the asset and therefore this indicator will point to it being an operating lease. However, it may be appropriate to disregard this indicator. Normally for there to be an operating lease with a significant part of the assets life remaining, there needs to be some realisation of funds through sale or further rentals. However, in the case of a specialised asset this will not normally occur, because it is of value only to the lessee. In these cases, the asset will normally transfer to the lessee at the end of the lease for a nil or nominal payment and be treated as a finance lease.

Where an asset has been leased several times during its economic life, and the lease is the last lease to take the asset to the end of its life, then many of the indicators may point towards a finance lease. For example, the present value of the minimum lease payments may approximate to the fair value of the asset at the inception of the final lease and there is unlikely to be an option to purchase the asset at fair value or to extend the lease at a market rent because the asset has reached the end of its life. However the asset will obviously be non-specialised and the final lease will not be for the major part of the economic life of the asset. The lease will be for the entire remaining useful life of the asset but IAS 17, *Leases*, focuses on economic life as an indicator of a finance lease. The lessor is recovering the investment in the asset through a number of leases and the substance of each of those leases will normally be an operating lease. Thus if the final lease were to be classified as a finance lease simply because of its position in the chain, this would normally be unacceptable. Where an asset is leased and rents are nominal rents, the agreement is still a lease under IAS 17. The total value of the rents will fall short of the fair value of the asset, thus indicating an operating lease. Often, the rents are low because a premium will have been paid up-front which may be equivalent to substantially all of the fair value of the asset. In this case, the lease is probably a finance lease. Where rents are very low and no premium has been paid, the lease does not have a commercial basis and it would appear that the lessor is indifferent to the risks and rewards of ownership. Lease classification, in this case, is better judged by looking at the substance of the arrangement and the intentions of the lessor in granting a lease on such terms.

The presence of an option to extend the lease at substantially less than a market rent implies that the lessor expects to achieve its return on investment solely through the lease payments and therefore is content to continue the lease for a secondary period at a nominal rental. This is an indicator of a finance lease. It is reasonable to assume that the lessee will extend the lease in these circumstances. However, an option to extend it at a market rental may indicate that the lessor has not achieved its return on investment through the lease rentals and therefore is relying on a subsequent lease or sale to do so. This is an indicator of an operating lease as there will be no compelling commercial reason why the lessee should extend the agreement. The absence of any option to extend the lease does not provide evidence either way as to an operating or a finance lease and other factors will need to be considered to determine the classification.

In some cases, fluctuations in the fair value of the residual interest in the leased asset are passed back to the lessee. This indicates that the lessee is bearing the residual value risk, and the lessor's return on investment is effectively fixed.

These indicators provide evidence of a finance lease. If the lease also requires the lessee to make good to the lessor any shortfall between the sale proceeds and a fixed 'residual' amount, then again this is evidence of the lessor's return being fixed. Where the lessor retains the proceeds of the eventual sale of the asset, the lessor is bearing the residual value risk and where the sale proceeds are significant, then this could be evidence of an operating lease.

Issues sometimes arise in lease contracts where an asset is held on a finance lease and then it is all or partially sub- let to another party on identical terms and conditions. This can occur where several entities intend to share leased accommodation and arrange for one entity to lease the whole asset and then sub-let the relevant parts to the others. The issue that arises here is whether the lead entity should recognise the finance leases on a gross basis in its accounts or whether it should net off the transactions in its accounts.

In this case the entity should currently look at the de-recognition requirements of IAS 39, *Financial Instruments: Recognition and Measurement*. The treatment will depend on the terms of the individual transaction. If the two transactions are separate to the extent that the lead entity is liable to pay its rentals under the head-lease regardless of whether it actually receives its sub-lease rentals, then the de-recognition requirements will not be met and it will need to account for the two leases on a gross basis.
A contingent rent is such amount that is paid as part of lease payments but is not fixed or agreed in advance at the inception of lease rather the amount to be paid is dependent on some future event. However, it is not an interest payment as it is not connected with the passage of time therefore time value of money is not an issue. Contingent rent is commonly connected with an increase or decrease in future sales by the lessee or increase or decrease in the use of asset or inflation or deflation. Under IAS 17, contingent rents are excluded from minimum lease payments and are accounted as expense/income in the period in which they are incurred/earned.

If a lease contains a clean break clause, where the lessee is free to walk away from the lease agreement after a certain time without penalty, then the lease term for accounting purposes will normally be the period between the commencement of the lease and the earliest point at which the break option is exercisable by the lessee. If a lease contains an early termination clause that requires the lessee to make a termination payment to compensate the lessor such that the recovery of the lessor's remaining investment in the lease was assured, then the termination clause would normally be disregarded in determining the lease term. Similarly the same principle applies, if the lease agreement states that the lease can only be terminated in remote circumstances, with the permission of the lessor or on entering a new lease agreement for the same or equivalent asset.

The IASB is preparing a standard that may clarify and change some of the above aspects of lease accounting. The current models lead to a lack of comparability and undue complexity because of the distinction between finance and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases which makes the deliberations of companies regarding classification of leases somewhat a futile exercise.

Written by a member of the Paper P2 examining team