LEASE ACCOUNTING: SPECIFICS

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Abstract: IFRS 16: "Lease", which replaced the applicable lease standard (IAS 17), brought about certain changes in accounting. According to the applicable standards, the lessee is obliged to apply a uniform financial model to the accounting operations.
In January 2016, the IFRS Board adopted IFRS 16 "Lease", which replaced IAS 17 of the same name applied since 1982. The new standard is the result of the joint work of the two major accounting systems: the International Accounting Standards Board and the US General Accepted Accounting Principles (US GAAP). It is also a logical sequence of IAS 17 approaches. The lease standard was developed because, not infrequently, the companies used the lease contract to finance acquisition of long-term assets without posting their controlled assets or contractual obligations in the balance, which resulted in inappropriate submission of the financial reports. Consequently, the financial report users obtained inaccurate information and had to assess the off-balance lease liabilities.
Therefore, the IFRS Board decided on the new approaches to accounting. In view of deficiencies of the applicable standards, the aim of the new standard (IFRS 16 "Lease") is supply the information users with the appropriate and fair lease-related information.
Within the frameworks of IAS 17, all the lease contracts were divided into two types: the financial lease, which actually has to do with the acquisition of the long-term assets and the operational lease, which does not have anything to do with it. In case of the financial lease, in its statement of financial position, the lessee was to recognize its controlled asset and lease liability, while in the operation lease the lessee equally assigned the rental to the costs throughout the lease term.

Keywords - Identification of lease, investment property lease, fixed taxes, interest rate, unwarranted residual value.

I. INTRODUCTION

Application of IAS 17 showed that even when leasing the most important assets of a business, the lessees can formally classify the contracts as operational lease.
Understandingly, the financial statement users would not be pleased with it. Therefore, the new standard states that the lessees recognize all the lease contracts (save exceptional cases) by means of a uniform model, i.e. as the lease assets and obligations regarding the lessors.
As to the contract recognition requirements regarding the lessors set out in IAS 17, in the new standard, they are virtually unchanged. The publication aims at discussing recognition of the lease contracts by the lessee.
Exceptions from the regulation are the contracts below:

- the short-term lease contract of not over 12 months (although if here is an option of purchasing the core asset, a lease contract cannot be regarded a short-term);
- the lease contract under which the price of the core asset is small (5000 USD).

In this case, employing the linear method the lessee may decide to recognize the lease payments as costs incurred during the lease term or employ another systematic approach[1].
Also, small value of the core assets should be defined by a new asset (not used as yet) and consolidated in the accounting policy as the absolute total.
Suppose that under the accounting policy, the small value asset is not to be worth more than 5000 USD. A company leases second-hand office furniture worth 1000 USD for the term of two years. If it had purchased similar new office furniture, it would have cost 3000 USD. Besides, the company rents a second-hand car worth 4000 USD for the same term because a new one costs 15000 USD. In this case, only lease fee of the furniture should be recognized as costs by the linear method. As to the car lease, it should be recognized as the leased asset (right to lease) and obligation[2].
If a short-term contract is modified (change of terms or prolongation), it is deemed a new contract. Let's discuss the situation in Georgia. In order to avoid mandatory registration with the Public Registry of the right to leases to the real estate, quite often companies conclude short-term (up to 1 year) office lease contracts. As the expiration date draws nearer, the lessor and the lessee a new short-term contract (usually of 11 months), so that they do not have to register their rights. Under IAS 17, does conclusion of the short-term contracts allow us[3]:

- to avoid mandatory recognition of the leased asset (right to lease) and obligation in the financial report?
- to assign the lease payments to the costs computed by the linear method?

To answer the question, we have to analyze the contract terms, prolongation of the contract with the same terms and conditions or conclusion of a new one in terms of legally protected rights and obligations. If there are none, for the purposes of IRFRS 16, the contract may be deemed shirt-term.
However, large companies that would not like to expose stability of their business do not execute the

short-term lease. Not infrequently, they conclude an agreement, which virtually envisages prolongation of the contract by the lessee. Under IFRS 16, section 2, the lease contract and lease agreement are to be considered as a single contract. Then IFRS 16, section 18 under which an organization is to define the lease term in consideration of the lease prolongation parameters and its own intention regarding the use of lease comes into play[4].

Presumably, in terms of IFRS 16, most of the short-term contracts will prove to be long-term and require the right to use the leased asset and recognition of the lease obligation.

Let's get back the principal accounting model in which the lessee is obliged to recognize the leased asset (right to lease and obligation) in the financial statement. Let us begin the analysis with the assessment of the lease obligation, since the first part of the accounting transaction (debit) will be an element of initial assessment of the right to lease.

II. LEASE OBLIGATION: ASSESSMENT

By the lease commencement date, the lessee is to assess the lease obligation by means of the original, direct and estimated recoverable expenses of the lease payments.

The lease payment includes[5]:

- fixed payments;
- estimated value of the variable payments, which depends on a certain index or rate (e.g. the LIBOR rate or change level of the consumer prices) by the lease commencement date;
- estimated value of the acquired asset, if there is certainty that the lessee will exercise this rights;
- the guarantee sum payable by the lessee to the lessor;
- the price or penalty payable in case of pre-term termination of the lease contract is the lessee is expected to exercise the right.

The future incentive payments payable by the lessor to the lessee are to be deducted, too.

The lease payments are to be discounted at the interest rate specified in the lease contract. If the interest rate is hard to determine, the lessee is to apply the one it will be able to take out the loan.

The interest rate under the lease contract is the one in case of which the current and unwarranted residual value of the lease payment equals the actual value of the core asset and the initial direct costs incurred by the lessor[6].

The unwarranted residual value is a part of the core asset's residual value, the sale of which by the lessor is not guaranteed by a third person or is warranted by only the person associated with the Lessor.

The unwarranted residual value is essentially quite similar to the ordinary residual value of the fixed assets. In both cases it is a forecast /estimated value. The only material difference is that the residual value of the fixed assets is the sale price (save the sale costs), which would be obtained if the asset were in the condition it will be at the end of its useful life. That is to say, the residual value of fixed asset is estimated at the current time.

The unwarranted residual value is the estimated sale price of the core asset by the lease end, i.e. the future value of the asset. Material condition associated with the unwarranted residual value is absence of the third persons' guarantee that the lessor can sell the core asset for the said price (i.e. we are expected to be able to sell the core asset at the said price however, it cannot be guaranteed).

The question may arise: is the lessee defines the interest rate, how can it estimate the lessor's original direct costs? In this case, the lessor's direct costs are estimated on the basis of the public information. For instance, at the contract registration time, the lessee is obliged to pay certain due or commission to the registering authority.

Since the lessor will be fully aware of its direct costs relevant to the contract, the interest rates calculated by the lessor and the lessee may differ.

III. RECOGNITION OF THE RIGHT TO USE THE LEASED ASSET

By the lease commencement date, the lessee is to assess the leased asset at its original value in terms of the right to use it, which includes:

- assessment of the original value of the obligation;
- the lease payments by the lease commencement date, save the incentive payments;
- the lessee's initial costs relevant to the lease contract;
- the core asset dismantlement, restoration or relocation approximate costs under the lease contract. The costs are estimated according to IAS 37: "Provisions, Contingent Liabilities and Contingent Assets".

Let us discuss the original value elements in some detail:

Prepayment under the lease contract. The payments effected prior to conclusion of the lease contract (prepayment) or by the commencement date of the lease included only into the original value of the asset (the right to use) but disregarded in the computation of the lease liabilities.

The lessor's incentive payments. Not infrequently, the lessor pays the lessee a certain sum (an incentive, bonus), so that the latter concludes the lease contract. That's what the owners of office areas offering their offices often do at the time of low demand. The same is true for car and machinery manufacturers, who offer the prospective clients to test trial them for a certain period of time (lease of the machinery to the prospective buyer).

Accounting the incentive payment was not clearly defined in IAS 17. Therefore, IFR Interpretations Committee (IFRIC) had to issue a special document: SIC 15: Operating Leases - Incentives" under which the lessee envisaged the lessor's incentives as the deferred income to be proportionately reflected in the profit and loss as reduction of the lease costs[7].

In IFRS 16, the IASB decided on a simple and clear solution: inclusion of the lessor's incentive payments into the original value of the leased assets (right to lease). The approach made separate accounting of the incentive payments irrelevant and, consequently, their division into the long- and short-term ones in the statement of financial standing.

Approximate costs of dismantlement, restoration or relocation of the core asset. This section is much like an element of initial costs of the fixed assets (estimated expenditure for dismantlement and restoration of their space). However, according to the lease contract, the estimated expenditure is relevant to leased core asset[8].

Let's say, a company leased a land for the term of 50 years and set up an industrial enterprise. Under the lease contract, the land is to recover its original condition, i.e. in 50 years, the company is to dismantle the industrial enterprise and restore the land to its original state. Which asset are the dismantlement and land restoration costs to be assigned to: the fixed assets or leased asset (right to lease)?

In this case, the costs belong to the fixed assets (the enterprise) and are to be included in the original value. For instance, if a company leased equipment for 5 years, under the lease contract, it is obliged to take it back to the lessor's premises. Otherwise, it will have to pay the lessor the equipment dismantlement costs and transportation costs. In this case, the company will include the estimated expenditure into the original value of the asset by way of the right to use.

IV. HOW TO CONSIDER THE FUTURE RIGHT TO USE

Upon the initial recognition, the lessee is to assess the leased asset with the right to use and account it at its original value by the accounting model, which is somewhat similar to the one for accounting the fixed assets at their original value. The difference between the two models is that reassessment of the lease liability is included into the balance value of the leased asset (right to lease).

Thus, the accounting model at the original value implies accounting the leased asset (right to use) at the original value, save the accumulated amortization and devaluation loss and, also, adjustment of the revaluation of the lease liability.

The Right to Use: Alternative Model of Accounting

IFRS 16 describes to other models, which may be employed for the right to use the leased asset[9]:

- the model of accounting at the real price based on IAS 40: "Investment Property";
- the model of accounting at the revalued price based on IAS 16: "Fixed Assets".

If, under IAS 40, for the investment property a company employs the model of accounting at the real price[10], it will be obliged to employ the model with the right use the leased assets, which correspond to the definition of the investment property.

If, under IAS 16, the company employs the model of accounting at the revalued price with regard to a certain class of the fixed assets, it can do so with the right use to the leased assets, which also fall into the same class fixed assets.

While employing the said accounting models, special attention should be paid to the following: the lessee company has the right to employ the model of accounting at the real price and it is also the same obligation as in the employment of the model of accounting at the revalued price.

The aforesaid models cannot be used in the lease of the core asset as the investment or fixed assets, which are accounted by the company at the revalued price. The right to use must correspond to the definition of investment property or fixed assets, i.e. the lease term should be fairly long, so that the right to use the real estate makes it possible to sublease it or/and get income from a lager value of the capital (lease of the real estate in the future for the purpose of sale of the right to use to a third person when the real price of the right to lease increases). The situation is about the same where the fixed assets are concerned: Their lease term should be fairly long. Also, the lease contract may provide for assignment to the lessee of the property right to the core asset[11].

V. ACCOUNTING ACQUISITION OF THE CORE ASSET AT THE LEASE END

The lease contract is to envisage assignment to the lessee of the right of property to the core asset or the right of its acquisition at the lease end.

As a matter of fact, this kind of contract includes:

- the right to use the leased asset for a certain term;
- acquisition of the leased core asset, if the lessee intends to exercise the acquisition right.

IASB suggests accounting the aforementioned transactions together. In this case, the leased asset with the right to use it depreciates **not during the lease term** but during its useful life.

The approach significantly facilitates accounting: one does not have to determine, which part of the lease payments (including the right to acquire) directly belongs to the right to use the leased asset and which

is the advance payment for its acquisition. Not infrequently, the leased asset may be acquired at much a smaller price than the market price, since the redemption of the leased asset has already been included into the lease payments or may envisage payment of a small sum.

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