To lease or not to lease?

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by Filbert Tsai - April 10, 2016

First of two parts

It is quite a famous line in the accounting industry that the then chairman of the International Accounting Standards Board (IASB), Sir David Tweedie, usually joked about wanting to see the aircraft he's riding on the balance sheet, and now, here it is. The new lease standard issued in January provides a new wave of interest for accounting professionals not certain of the impact of the new accounting standard.

International Financial Reporting Standards (IFRS) 16 "Leases" is the new lease standard replacing International Accounting Standards (IAS) 17 "Leases" among others. The new lease standard is not getting the spotlight needed since most of the companies are still focused on understanding the implications of IFRS 15 "Revenue from contracts with customers" and probably IFRS 9 "Financial instruments." Although news articles accompanying the release of IFRS 16 is often marred by the huge amount expected to be put on balance sheet when the new lease standard kicks in on January 1, 2019, probably, it is more of a matter of understanding what the financial effects will be than being shocked with big numbers reported.

This article will not focus on the technical requirements of the new lease standard. Rather, this article will be focused on the financial implication of the new lease standard. Also, just to highlight, the focus of this article will just be on the impact on lessee accounting for operating leases since accounting for finance leases (or capital leases) and lessor accounting remains similar, albeit with some clarifications but are mostly
nitty-gritty.

The new lease standard requires operating leases to be reflected in the balance sheet as both an
asset and a liability. Under IAS 17, operating leases are recognized using the straight-line lease recognition principle in which lease expenses, other than contingent rent, are recognized evenly throughout the lease-term (in contrast to the requirement under UK GAAP to consider the first break-clause) with the difference between actual lease payment and straight-line lease expense taken to
balance sheet.

On initial recognition the asset (i.e., right of use asset) and the lease obligation will be recognized at present value using the incremental borrowing rate if the rate implicit in the lease is not readily determinable (in practice, the rate implicit in the lease in an operating lease is usually not readily determinable in contrast to a finance lease). For business readers, the rate implicit in the lease is basically the effective discount rate (or internal rate of return for simplicity) if cash payment will be made for the leased asset (which is usually indicated as the cash purchase value in a finance lease), while the incremental borrowing rate is the market interest rate if the company is to obtain financing to acquire the leased asset.

Sounds complicated? This corner will present an illustrative example to hopefully simplify the new rules for accounting of leases in the next week's column.

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