To lease or not to lease?

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Conclusion

THE example below will illustrate the new rules under International Accounting Standards (IAS) 17 on the accounting treatment of leases.

Assume that Company A obtains a five-year lease for P10,000 per year with annual increment on P1,000. The incremental borrowing rate for the lease is 6.04 percent, which gives a present value of P50,000 for the leased asset. Under IFRS 16, P50,000 will be recognized as a right of use asset and a lease obligation on the first day of the lease (or zero impact on balance sheet) in which under IAS 17, nothing will be recognized on the first day.

Under IAS 17, the lease would then be recognized using the straight-line method over five years (assuming that years is the rational basis for straight-line allocation) amounting to P12,000 each year. The following table summarizes the accounting impact of this approach:

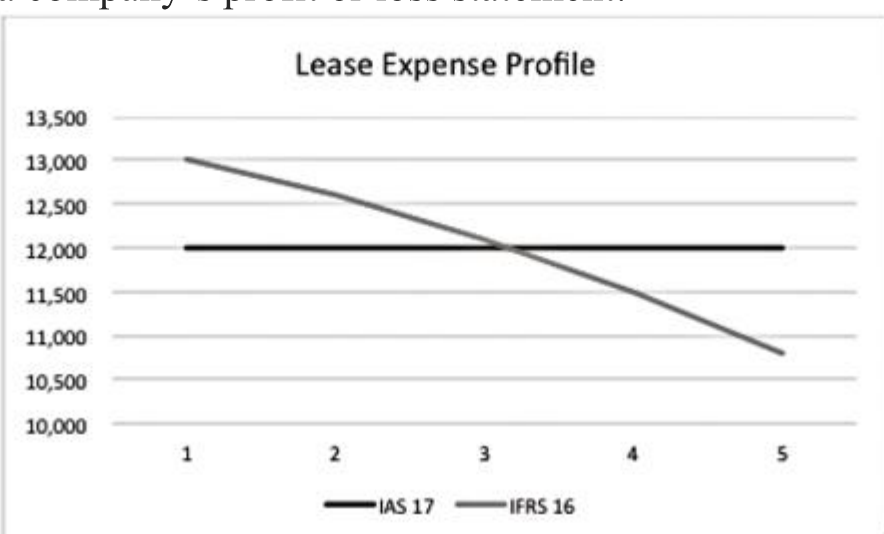
Year	Lease Payment	Straight-line Expense	Asset (Liability)
1	10,000	12,000	(2,000)
2	11,000	12,000	(1,000)
3	12,000	12,000	–
4	13,000	12,000	1,000
5	14,000	12,000	2,000
Total	60,000	60,000	–

In contrast, adopting the new lease standard will require the recognition of the right of use asset and the lease obligation on day 1 with the right of use asset amortized over the term of the lease (or asset life if shorter) using straight-line method and the lease obligation amortized using the effective interest rate over the settlement period. Continuing on the above example, the table below summarizes the accounting implication of this requirement:

Year	Asset Amort.	Right of Use Asset	Interest Amort.	Payment	Lease Liability	Total Amort.	Net amount in balance sheet
0		50,000			50,000		-
1	10,000	40,000	3,020	10,000	43,020	13,020	(3,020)
2	10,000	30,000	2,599	11,000	34,619	12,599	(4,619)
3	10,000	20,000	2,091	12,000	24,710	12,091	(4,710)
4	10,000	10,000	1,493	13,000	13,203	11,493	(3,203)
5	10,000	-	797	14,000	-	10,797	-
Total	50,000		10,000	60,000		60,000	

As can be seen in the table above, total expense recognized over the lease term will be the same (i.e., P60,000) but the expense recognition profile is radically changed. Under the new lease standard, the straight-line lease expense is now split between the asset amortization expense and financing expense which results to different amount of lease expense being recognized.

The chart below is helpful in understanding the impact of the new lease standard on a company's profit or loss statement:



As seen in the lease expense profile graph above, the lease expense under IAS 17 represents a straight-line lease expense which remains equal throughout the lease term while adopting the requirement of IFRS 16 will result to a declining amount of lease expense due mainly to the impact of the lease obligation amortization using the effective interest rate method.

Effectively, the straight-line lease expense is still recognized under IFRS 16 through the asset amortization model as can be seen in the graph above. This approach is consistent with the current accounting treatment of finance leases (or capital leases) in which expense is recognized through depreciation and interest.

As these are new financial statement captions, it is good to know that the right of use asset is considered nonmonetary asset, while the lease obligation is considered a monetary liability for foreign-exchange denominated transaction purposes. So if there are leases denominated in foreign-currency, additional complexity should be considered since the expense profile could materially swing due to the revaluation of the lease obligation at period-end. The new lease standard can be a game changer for some industries and could have potential significant impact on balance sheet and income statement, but for most of the companies, this new requirement will not be really relevant due to the low-value nature of the leased assets.

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