

IFRS Update Webinar – 14 April 2015

Q. Isn't a lease a contract and therefore be included in the financial statements?

A. A lease is indeed a contract between a lessee and a lessor whereby the lessee obtains an asset from the lessor for use in the business. A lease must be included in the financial statements and is (currently) accounted for under the provisions in IAS 17 *Leases*. Under IAS 17 a lease is accounted for as either an 'operating' lease or a 'finance' lease.

An operating lease is where the risks and rewards of ownership of the leased asset remain with the lessor. When a lessee enters into an operating lease the lease rentals are simply charged to the statement of profit or loss on an arising basis and no other entries are required in the financial statements.

When the risks and rewards of ownership of the leased asset transfer to the lessee, the accounting becomes a little more complicated because the lease is then classified as a finance lease. Under IFRS, a reporting entity has to report the 'substance' of transactions and not merely their legal form and leasing perfectly illustrates this concept. In a finance lease, the lessee has acquired an asset for use in its business and because the risks and rewards of ownership of this asset transfer to the lessee from the lessor, the asset is recognised on the statement of financial position as a non-current asset, together with a corresponding lease payable representing the leasing obligations which are to be paid to the lessor over the life of the lease. A finance lease is recognised on the statement of financial position because, in substance, the lessee has acquired an asset which has been financed through a leasing transaction.

Because some leases are deliberately engineered to result in an operating lease; or leases are, in some cases, deliberately kept off the statement of financial position, this causes what is commonly referred to as 'off balance sheet finance' which distorts the financial statements and this is why the International Accounting Standards Board are going to issue a new leasing standard in 2015 which will require all leases, other than short leases (i.e. those with 12 months or less to run) and leases for small assets (e.g. computers), to be reported on the statement of financial position as a finance lease.