 **Accounting for leases under IFRS**  
A European perspective  
October 2008

KPMG International Financial Reporting Group

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## Agenda

- Introduction**
- Finance leases and operating leases
- Lease classification
- Some practical issues
- Determining whether an arrangement contains a lease
- Future developments

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## Introduction

*“A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time” (IAS 17.4)*

**IFRIC 4 elaborates on factors to consider when assessing if an arrangement is a lease**

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## Finance lease

Lease that transfers substantially all of the risks and rewards to the lessee



## Operating lease

Lease that does not transfer substantially all of the risks and rewards to the lessee



## Balance sheet impact - Summary

	Operating lease	Finance lease
Lessee	Off balance sheet	<b>Leased asset</b> <b>Lease liability</b> (PV of minimum lease payments)
Lessor	<b>Leased asset</b> Substance over form!	<b>Lease receivable</b> (PV of gross investment)

## Disclosures

Disclosures include:

- Commitments under non-cancellable leases by period
- Future minimum lease payments (< 1 year, 1–5 years, >5 years)

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## Classification

**The overriding principle**

**Substance over form**

**The key question**

**Have substantially all risks and rewards of ownership of the leased asset been transferred to the lessee ?**

**Timing of classification**

**At the inception of the lease**

## The overriding principle

Does the lease transfer substantially all of the risks and rewards of ownership of the leased asset to the lessee?

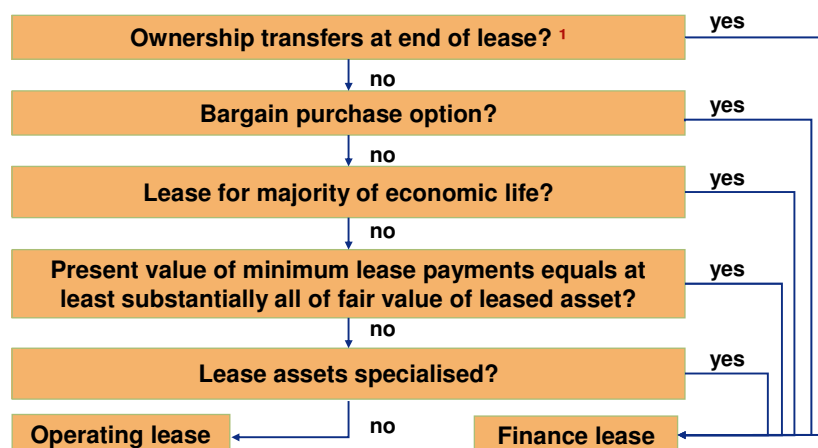
- Ask “does the lessor earn a substantially fixed or variable return form the leased asset?”
- Typically, this is a more important question than “does title transfer?”



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## Indicators of a finance lease



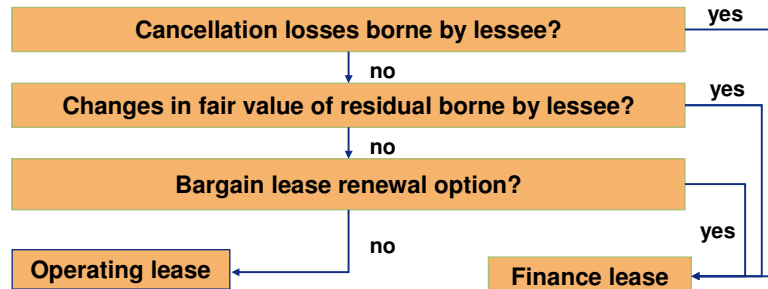
<sup>1</sup> Unless the transfer is at fair value



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## More indicators of a finance lease



## Timing and classification

Lease classification is assessed on inception of the lease

- Generally, reassess if there is a change in the terms of the lease

Also consider the conditions on inception of the lease when assessing lease classification

- On transition to IFRS
- Following a business combination

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## IT equipment

### Example

- A legally owns a computer
- B leases the computer for a fixed term of 4 years
- At the end of 4 years, the computer will be returned to A
- The contract is non-cancellable

Who “owns” the computer economically?

## Common issues in IT leases

### Estimating residual values

- Secondary market
- Technological obsolescence

### Purchasing and renewal options

- Pricing
- Business continuity



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## Real estate leases

Leases of land and building are classified as operating or finance like leases of other assets

- Separate consideration of land and building elements:
  - Land: usually operating lease (indefinite economic life), unless title passes by the end of the lease term
  - Buildings: apply criteria as described

Minimum lease payments are allocated to land and buildings based on relative fair values of leasehold interests in land and buildings elements

- If reliable allocation is not possible, treat both as finance lease unless it is clear that both elements are operating leases



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## Common issues in real estate leases

Land vs. building

Estimating residual values

- Long lease terms

Common rental terms

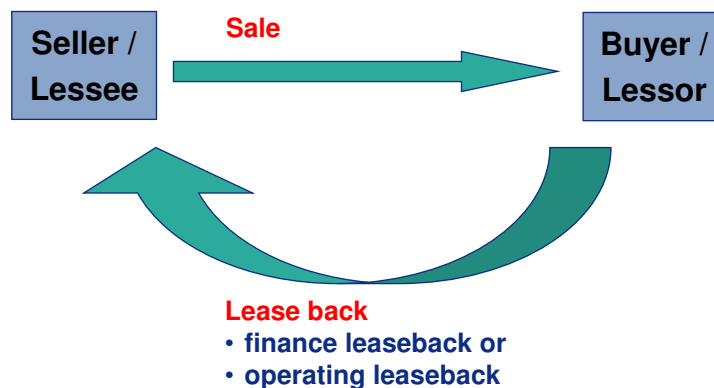
- Market rent review
- Turnover rents
- Rents based on consumer price indices
- Rents based on interest rates



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## Sale and leaseback transactions



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## Common issues in sale and leaseback transactions

### Profit/loss recognition on inception

- Is the transaction at fair value?

### Arrangements at the end of the leaseback

- Residual value
- Profit sharing
- Purchase options

### The buyer/lessor

- Is the buyer/lessor a SPV?
- Who should consolidate the buyer/lessor?



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## Other issues: operating leases

### Uneven lease payment profile

- Spread on straight line basis over lease term
- Balance sheet will reflect deferral or prepayment

### Lease incentives

- Spread on straight line basis over lease term

### Annuity depreciation

- Is not allowed



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## IFRIC 4 - determining when an arrangement contains a lease

An arrangement that is not in the legal form of a lease may be or contain a lease

The assessment of an arrangement and the identification of a lease should be based on the substance of the arrangement

The factors to consider are

- “fulfilment of the arrangement is dependent on the use of a specific asset or asset(s)”
- The arrangement conveys a right to use the asset(s)

## Specific asset or assets

Does the arrangement specify the asset or asset(s)?

- Specification may be embedded in the contractual arrangement
- Implicit specification may arise if the asset is:
  - Large
  - Specialised
  - Only one of its type owned by the entity (lessor)



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## Example

Company A enters into an agreement with Supplier B relating to packaging of bottles into crates for a three year period. The contract specifies the following:

- The bottling plant is explicitly identified in the arrangement
- The bottling plant is only used to perform packaging of bottles for Company A and it would neither be economically feasible or practicable for Supplier B to use other assets
- Each month Company A pays a fixed price amounting to CU 100,000
- Company A has the option to change the supplier without losing the control over the bottling plant and hence, it is also able to prevent others from getting physical access to the bottling plant



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## Future developments

### IASB/FASB Discussion Paper

- Expected late 2008

### Lessee accounting only

### Lessees to recognise assets and liabilities arising from leases

- “Right to use” assets
- Liabilities to pay rentals

### New standard 2011?



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**Contact details**  
**KPMG IFRG Limited**  
**+44 (0)20 7694 8871**  
**[www.kpmgifrg.com](http://www.kpmgifrg.com)**

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