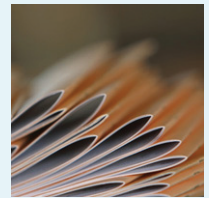




BDO Dunwoody LLP
Chartered Accountants
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Canadian GAAP - IFRS Comparison Series

Issue 8 – Leases



Both IFRS and Canadian GAAP are principle-based frameworks and, from a conceptual standpoint, many of the general principles are the same. However, the application of those general principles in IFRS can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between the two, it is essential to look beyond the general principles and examine the detailed guidance provided in the standards. This is our eighth issue in a series of publications which will provide detailed information on the key differences between IFRS and Canadian GAAP.

In this issue, the focus will be on the recognition and measurement of leases, including:

- The classification of leases;
- Leases in the financial statements of lessees;
- Leases in the financial statements of lessors; and
- First time adoption of IFRS issues.

Be advised that this publication is a guide to the differences between Canadian GAAP and IFRS and is not meant to be a comprehensive manual. Please contact a BDO Dunwoody representative for specific details and information.

References

IFRS: IAS 17, Leases, IFRIC 4, Determining whether an Arrangement contains a Lease, SIC 15, Operating Leases - Incentives, SIC 27, Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

Canadian GAAP: Section 3065, Leases, EIC 150 – Determining whether an Arrangement contains a Lease, EIC 19 – Minimum Lease Payments and Contingent Rentals, EIC 21 – Accounting for Lease Inducements by the Lessee, EIC 25 – Sale with Leasebacks, EIC 85 – Sellers Retention of Substantial Risks of Ownership – Application of CICA 3065.61.

Classification of Leases

Canadian GAAP and IFRS are similar standards in that they both require an entity to make a classification of leases based on whether substantially all of the benefits and risks of ownership have been transferred to the lessee. However, there are differences in how to classify leases and the terminology used in each standard.

Canadian GAAP	IFRS
<p>Leases are classified based on whether or not substantially all the risks and rewards incidental to ownership are transferred, as follows:</p> <ul style="list-style-type: none"> From the point of view of the lessee: capital and operating leases; and From the point of view of the lessor: sales-type, direct financing and operating leases. 	<p>Leases are classified at the inception of a lease (the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease) as a finance lease or an operating lease, based on whether or not substantially all the risks and rewards incidental to ownership are transferred.</p> <p>A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. A finance lease is similar to a capital lease under Canadian GAAP.</p>
<p>One or more of the following conditions is required to be present for a lessee to classify a lease as a capital lease, sales-type lease or direct financing lease:</p> <ul style="list-style-type: none"> Ownership will be transferred to the lessee by the end of the lease term or the lease provides for a bargain purchase option; The lessee will receive substantially all of the economic benefits to be derived from the leased property when the lease term is equal to a major portion (usually 75 percent or more) of the economic life of the leased property; or The present value, at the beginning of the lease term, of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (usually 90 percent or more) of the fair value of the leased property, at the inception of the lease. <p>A lessee requires one or more of the conditions above to be present, whereas all of the conditions below for lessors usually need to be met. These conditions are:</p> <ul style="list-style-type: none"> Any one of the conditions above for lessees; The credit risk associated with the lease is normal when compared to the risk of collection of similar receivables; and The amounts of any unreimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated. 	<p>The standard does not provide separate guidance for lessees and lessors when determining the classification of a lease. Instead, examples are provided of situations that individually or in combination would normally lead to a lease being classified as a finance lease. These are:</p> <ul style="list-style-type: none"> The lease transfers ownership of the asset to the lessee by the end of the lease term; The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised; The lease term is for the major part of the economic life of the asset, even if title is not transferred; At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and The leased assets are of such a specialised nature that only the lessee can use them without major modifications. <p>The standard does not provide any quantitative thresholds which need to be achieved. Canadian GAAP is not strictly a quantitative threshold but generally in practice these have been interpreted as bright lines and used in this way. As a result, more judgment may be required by Canadian entities when determining the classification of a lease arrangement rather than just meeting the quantitative threshold.</p>

Canadian GAAP	IFRS
<p>The other conditions have been advanced as evidence that substantially all the benefits and risks of ownership have been transferred to the lessee, although these other conditions by themselves are not sufficient evidence that substantially all the benefits and risks of ownership have been transferred to the lessee. These conditions are:</p> <ul style="list-style-type: none"> • Lessee pays cost incident to ownership; • Lessee has the option to purchase the asset for the lessor's unrecovered investment; • Leased property is special purpose to the lessee. 	<p>Other indicators that individually, or in combination, could also lead to a lease being classified as a finance lease are:</p> <ul style="list-style-type: none"> • If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee; • Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and • The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
<ul style="list-style-type: none"> • A renewal, an extension or a change in the provisions of an existing lease would be considered a new lease, and classified based on the 'new' lease and accounted for prospectively over the remaining term of the lease. 	<p>The lease classification can be changed only when the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification if the changed terms had been in effect at the inception of the lease.</p> <p>Like Canadian GAAP, the revised agreement is treated as a new lease and accounted for prospectively over the remaining term of the lease.</p> <p>The standard also provides guidance in relation to changes in estimates (e.g. changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (e.g. default by the lessee). Any change in estimates or circumstances does not give rise to a new classification of a lease for accounting purposes.</p> <p>A change in estimate would also likely include the renewal of a lease or the execution of a purchase option, provided these were not considered probable at the inception of the lease.</p>
<p>Specific guidance is provided on how to account for the change in classification of a lease.</p> <p>For a capital lease replaced by an operating lease – the asset and related obligation are removed from the accounts of the lessee and the net adjustment is included in income of the period; and</p> <p>For a sales-type or direct financing lease replaced by an operating lease – the remaining net investment is removed from the accounts of the lessor and the leased asset is recorded as an asset at the lower of its original cost, present fair value amount or present carrying amount. The net adjustment is included in income of the period.</p>	<p>No specific guidance is provided on how to account for the consequences of modification of the lease terms.</p>

Leases involving Land and Buildings

While requirements for leases involving land and buildings are not as much of a matter of concern here in Canada as they may be in countries (where property rights are obtained under long-term leases and the substance of those leases differs little from buying a property), both IFRS and Canadian GAAP contain similar guidance on how to account for the leases. However, there are some differences in how these leases should be accounted for.

Canadian GAAP	IFRS
<p>Land and buildings are considered two separate leases for the purposes of classification only when:</p> <ul style="list-style-type: none"> • The lease terms do not allow ownership to pass; • The lease terms provide for a bargain purchase option; or • The fair value of land at the inception of the lease is significant in relation to the total fair value of the leased property. 	<p>Land and buildings are considered separately for the purposes of classification.</p> <p>However, in the following situations, separate classification of land and buildings may not always be possible or required:</p> <ul style="list-style-type: none"> • If an allocation between land and buildings cannot be made reliably, based on the minimum lease payments (including any lump-sum upfront payments) between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land and the buildings elements of the lease at the inception of the lease, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases in nature. In that case the entire lease is classified as an operating lease; • Similar to Canadian GAAP, when the amount that a lessee would initially recognize for the land element of a finance lease is immaterial, the land and buildings may be combined for classification purposes. Where the land and buildings are combined, the economic life of the buildings is regarded as the economic life of the entire leased asset; and • When the lessee’s interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. (Refer to Issue 5 of our Canadian GAAP – IFRS differences series).
<p>Leasehold interests in land are normally classified as operating leases unless there is reasonable assurance that ownership will pass to the lessee by the end of the lease term.</p>	<p>Leasehold interests in land are normally classified as operating leases with any payments made on entering into or acquiring the leasehold interest representing prepaid lease payments, and is amortized over the lease term in accordance with the pattern of benefits provided.</p>

Finance Leases in the Financial Statements of Lessees

Generally, IFRS and Canadian GAAP have similar requirements in relation to recognition of a capital/ finance lease by a lessee. Both IFRS and Canadian GAAP require recognition of an asset (by way of acquisition) and an assumption of an obligation (to pay future lease payments) based on the lower of either the present value of the minimum lease payments or the fair value of the leased asset. Subsequent to initial recognition, the asset is amortized over the period of expected use/useful life on a basis that is consistent with the lessee's depreciation policy for other similar assets. Lease payments are apportioned between a finance charge and a reduction of the outstanding liability. However, there are some differences in the requirements, which are set out in the table below:

Canadian GAAP	IFRS
<p>The discount rate used by the lessee in determining the present value of minimum lease payments is the lower of:</p> <ul style="list-style-type: none"> • The lessee's rate for incremental borrowing; and • The interest rate implicit in the lease, if practicable to determine. 	<p>If practicable, an entity is required to use the interest rate implicit in the lease as the discount rate in calculating the present value of the minimum lease payments. If not practicable, the lessee's incremental borrowing rate may be used.</p>
<p>Any initial direct costs of the lessee (e.g. for negotiating and securing leasing arrangements) are expensed.</p>	<p>Any initial direct costs of the lessee (e.g. for negotiating and securing leasing arrangements) are added to the amount recognized as an asset. Therefore, at the commencement of the lease term, the asset and the liability are recognized in the balance sheet at the same amounts except for any initial direct costs of the lessee.</p>
<p>If the lease does not contain terms that allow ownership to pass to the lessee or a bargain purchase option, the property is amortized over the lease term, rather than over the period of expected use.</p>	<p>If ownership of the asset is not expected to pass to the lessee at the end of the lease, then the asset is depreciated over the shorter of the lease term and its useful life.</p>
<p>The standard makes no reference to reviewing impairment on the leased asset. However, when following Canadian GAAP, there is a requirement to review impairment on an asset group basis and leased assets should be included in an asset group.</p>	<p>The standard includes a specific reference to an entity also being required to review impairment on the leased asset in accordance with IAS 36, Impairment of Assets.</p>

Operating Leases in the Financial Statements of Lessees

Both IFRS and Canadian GAAP require lease rentals or payments made under an operating lease to be recognized as an expense on a straight-line basis over the lease term, unless another systematic basis is representative of the time pattern of the user's benefit. Therefore, incentives received under an operating lease (such as rent-free periods or contributions by the lessor to the lessee's relocation costs) are recognized as a reduction in rental payments over the lease term, with each party using a single amortization method applied to the net consideration.

Finance Leases in the Financial Statements of Lessors Other than Manufacturers and Dealers

IFRS and Canadian GAAP have similar requirements in relation to recognition of a capital / finance lease by a lessor. However, there are some differences in the requirements, which are set out in the table below:

Canadian GAAP	IFRS
<p>Direct financing leases give rise to income in the form of finance income. This income is the difference between:</p> <ul style="list-style-type: none"> • The total minimum lease payments, net of any executory costs and related profit included therein, plus any unguaranteed residual value of the leased property accruing to the lessor; and • The cost or carrying amount, if different, of the leased property. 	<p>At the inception of the lease, lessors should recognize assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease, which is defined as the gross investment in the lease discounted at the interest rate implicit in the lease.</p> <p>The lease payment is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.</p> <p>Finance income is the difference between the gross investment in the lease and the net investment in the lease (i.e. the discounted amount).</p>
<p>Initial direct costs should be expensed as incurred and a portion of unearned income equal to the initial direct costs should be recognized in income in the same period.</p>	<p>Other than manufacturer or dealer finance, lessors' initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognized over the lease term.</p> <p>IFRS provides specific examples of initial direct costs that are often incurred by lessors. These include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease.</p> <p>IFRS specifically excludes general overheads, such as those incurred by sales and marketing teams, from being included in the initial direct costs.</p> <p>The interest rate implicit in the lease is defined as the discount rate that, at the inception of the lease, causes the aggregate present value of:</p> <ul style="list-style-type: none"> • The minimum lease payments; and • The unguaranteed residual value <p>to be equal to the sum of:</p> <ul style="list-style-type: none"> • The fair value of the leased asset; and • Any initial direct costs of the lessor. <p>Effectively, this definition automatically includes the initial direct costs in the finance lease receivable, therefore there is no requirement or need to add these costs separately to the finance lease receivable.</p>

Canadian GAAP	IFRS
<p>The estimated residual value would be reviewed annually to determine whether a decline in its value has occurred.</p> <p>If the decline in value is other than temporary, the accounting for the lease transaction would be revised using the changed estimate. The resulting reduction in the net investment in the lease would be charged to income.</p> <p>An upward adjustment of the residual value would not be made.</p>	<p>Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly, rather than specifically required to be on an annual basis.</p> <p>The income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognized immediately where there has been a reduction in the estimated unguaranteed residual value. There is no mention of the reduction being other than temporary.</p>

Operating Leases in the Financial Statements of Lessors Other than Manufacturers and Dealers

Both IFRS and Canadian GAAP require lease receipts under an operating lease to be recognized as revenue on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased property is utilized (e.g. a units of production or use allocation method). Incentives granted under an operating lease are, therefore, recognized as a reduction in rental income over the lease term. However, there are differences between IFRS and Canadian GAAP in relation to the treatment of executory costs and initial direct costs.

Canadian GAAP	IFRS
Lease receipts recognized under an operating lease exclude all executory costs.	Lease receipts recognized under an operating lease exclude only receipts for services provided, such as insurance and maintenance costs.
Initial direct costs incurred by lessors are recognized as an asset.	Initial direct costs incurred by lessors are required to be added to the carrying amount of the leased asset.

Leases in the Financial Statements of Manufacturers and Dealers

IFRS and Canadian GAAP have a similar concept for recognition of manufacturer and dealer leases: recognize an initial profit or loss on the sale of the product at the inception of the lease and finance income over the lease term. However, there are differences in how this recognized amount is determined.

Canadian GAAP	IFRS
<p>A sales type (finance) lease by a lessor gives rise to two types of income:</p> <ul style="list-style-type: none"> • The initial profit or loss on the sale of the product at the inception of the lease; and • Finance income over the lease term. 	<p>A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:</p> <ul style="list-style-type: none"> • Profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and • Finance income over the lease term.

Canadian GAAP	IFRS
When a lease is a sales-type lease, a sale should be recorded with the manufacturer's or dealer's profit or loss being recognized at the time of the transaction.	Manufacturer or dealer lessors should recognize selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.
The sales revenue recorded at the inception of a sales-type lease is the present value of the minimum lease payments net of any executory costs and related profit included therein, computed at the interest rate implicit in the lease.	The sales revenue recognized at the commencement of the lease term by a manufacturer or dealer lessor is the fair value of the asset (usually the cash price), or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest.
The discount rate for determining the present values would be the interest rate implicit in the lease.	Therefore, if artificially low rates of interest are quoted, selling profit is restricted to that which would apply if a market rate of interest were charged.
Initial direct costs are considered to be incurred in order to produce the sale; therefore, they would be recognized as an expense at the inception of the lease, and unearned finance income should be deferred and taken into income over the lease term to produce a constant rate of return on the investment in the lease.	<p>Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs.</p> <p>These costs are, therefore, excluded from the net investment in the lease and are recognized as an expense when the selling profit is recognized, which, for a finance lease, is normally at the commencement of the lease term. Note that this treatment is different to that for when a lessor arranges a finance lease; in that situation, the indirect costs are added to the finance receivable amount.</p>

Sales and Leaseback Transactions

Both IFRS and Canadian GAAP have similar general requirements in relation to the treatment of sale and leaseback transactions. However, there are differences in how the standards view profit or loss on sale and leaseback transactions resulting in an operating lease and in the exceptions from the general rules in each standard.

Canadian GAAP	IFRS
A lease in a sale-leaseback transaction is accounted for as a capital, direct financing or operating lease, as appropriate, by the seller-lessee and by the purchaser-lessor.	A lease in a sale-leaseback transaction is accounted for as a finance or operating lease, as appropriate, by the seller-lessee and by the purchaser-lessor.
<p>Any profit or loss arising in a sale and leaseback transaction that results in a capital lease is deferred and taken to income over the lease term, except:</p> <ul style="list-style-type: none"> • A loss is immediately recognized when, at the time of the sale-leaseback transaction, the fair value of the property is less than its carrying value; and • For leases involving land only, in which case the profit or loss would be amortized over the lease term on a straight-line basis. 	<p>If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortized over the lease term.</p> <p>There is no requirement for finance leases to recognize a loss when, at the time of the sale-leaseback transaction, the fair value of the property is less than its carrying value.</p>

Canadian GAAP	IFRS
<p>Any profit or loss arising in a sale and leaseback transaction that results in an operating lease is deferred and amortized in proportion to rental payments over the lease term except, a loss is immediately recognized when the fair value of the property at the time of the sale-leaseback transaction is less than its carrying value.</p>	<p>Profit or loss is recognized immediately when a sale and leaseback transaction results in an operating lease unless the sale price is:</p> <ul style="list-style-type: none"> • Below fair value, and the loss is compensated for by future lease payments below market price (the loss is deferred and amortized in proportion to the lease payments over the expected useful life of the asset); or • Above fair value. The excess over fair value shall be deferred and amortized over the period for which the asset is expected to be used. <p>Also, like Canadian GAAP, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value is recognized immediately.</p>
<p>EIC 25 - Accounting for Sales with Leasebacks permits immediate recognition of a gain when the seller leases back only a minor portion of the property sold.</p> <p>When the seller leases back more than a minor portion but less than substantially all of the property sold, the gain deferred and amortized is the amount allocable to the portion of the property covered by the leaseback agreement.</p>	<p>No specific guidance is provided in relation to a sale and leaseback transaction, which results in only a portion, minor or substantial, being leased back from the property sold.</p>

First Time Adoption Issues

An entity is required to follow IFRIC 4 - Determining whether an Arrangement contains a Lease, an interpretation providing guidance on determining if an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset in return for a payment or series of payments, is actually a lease. An entity is usually required to make this determination at the inception of the lease.

IFRS 1, First-time Adoption of International Financial Reporting Standards provides an exemption from this requirement as it allows a first time adopter to apply the transitional provisions of the interpretation. These allow an entity to make the determination to arrangements existing at the start of the earliest period for which comparative information under IFRS is presented on the basis of facts and circumstances existing at the start of that period. Effectively, as a result of this, a first time adopter is required to make the determination at the date of transition to IFRS.

IFRIC 4 is very similar to EIC 150 - Determining Whether an Arrangement Contains a Lease. Therefore, even if a Canadian entity elects to use the IFRS 1 exemption, the entity would again have to assess arrangements that have already been assessed under EIC 150. Many observers believe that reassessing items that have already been assessed under identical requirements of an entity's previous GAAP, is an ineffective use of resources during the conversion process. As such an exposure draft proposing an amendment to IFRS 1 was recently issued. The proposal is that, where an entity has made the exact same determination under a previous GAAP as that required by IFRIC 4, but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRS.

The Future of Leases under IFRS

The International Accounting Standards Board (IASB) is currently conducting a detailed project in relation to leases. According to the IASB work plan, a discussion paper is expected to be issued in the first quarter of 2009, and an exposure draft in 2010 with a final standard is to be issued in 2011. The discussion paper is expected to have some significant changes in how leases, especially operating leases, are accounted for.

The new standard is likely to be effective after the adoption of IFRS in Canada, although early adoption is likely to be permitted. If this is the case, then a Canadian entity may want to adopt the revised standard early to avoid a potential double change in accounting – i.e. i) on adoption of IFRS and ii) on adoption of the revised standard a year or so after adopting IFRS.

Conclusion

In general, the principles relating to accounting for leases under Canadian GAAP and IFRS have a lot of similarities. However, when looking at the details of each standard there are also some differences of which an entity needs to be aware and needs to determine whether these differences will have an impact on the way leases are accounted for upon moving to IFRS.

If you require further guidance on leases under IFRS or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.