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Column: LEADING THE WAY: IMPORTANT NEW GUIDELINES FOR LEASE ACCOUNTING

IMPORTANT NEW GUIDELINES FOR LEASE ACCOUNTING

LEADING THE WAY

PwC Thailand

Picture this scenario: A Thai production company (the purchaser) enters into an agreement with a gas supplier to supply a minimum quantity of gas needed in its production process for a specific period of time. The supplier designs and builds a gas production facility next to the purchaser's plant and maintains ownership and control over all significant aspects of operating the facility.

Securing gas from other sources is not economically feasible or practicable. Thus the purchaser commits to pay the supplier a fixed capacity charge and a variable charge based on actual production taken. The fixed capacity charge applies regardless of the actual production taken.

The production company is meticulous when doing the accounting for the production project. However, it makes a vital mistake in interpreting the agreement with the gas supplier. According the interpretation of Thai Financial Reporting Standards 4 (TFRIC 4), when it entered into the agreement to purchase gas, it inadvertently agreed to lease the gas supplier's facility. Not accounting properly for this "lease" results in an error on the financial statements.

This article highlights the issues companies may face in regard to "lease accounting".

Notifications relating to the interpretation of TFRIC and accounting guidance issued by the Federation of Accounting Professions (FAP) were promulgated on Jan 17, 2013 in the *Royal Gazette*. TFRIC 4 ("Determining whether an arrangement contains a lease") is one of them. It is effective for the accounting periods beginning on or after Jan 1, 2014.

IFRIC 4 helps companies assess whether they have a "plain-vanilla" supply contract or whether, in substance, there is actually a lease embedded in the contract.

Companies sometimes enter into arrangements that do not take the legal form of a lease but which nevertheless convey a right to use an asset in return for a payment or series of payments. Examples a supplier may convey such a right to use an asset to a purchaser, often together with related services, include:

✦ outsourcing arrangements (e.g. data processing functions);
✦ services that require specific equipment (e.g. drilling rig services may be considered as leasing rig equipment); and
✦ take-or-pay and similar contracts, calling for specified payments regardless of whether a purchaser takes delivery of the contracted products (such as gas) or services.

Under TFRIC 4, determining whether an arrangement is, or contains, a lease requires the purchaser to assess whether:

a) fulfillment of the arrangement is dependent on the use of the specific asset(s); and

b) the arrangement conveys a right to use the asset.

The following questions arise: Has the asset been implicitly specified in the arrangement? Does the supplier own or lease only one asset with which to fulfil the obligation? Is it commercially feasible or practical for the supplier to fulfil the arrangement by providing use of alternative assets?

In the example we used earlier, it is clear that fulfilment of the agreement is dependent on the use of the facility built next to the purchaser's plant. Therefore, the first criterion in TFRIC 4 is met even if this agreement does not specifically identify the asset. For the second criterion, an arrangement may be considered to convey a right to use the asset(s) if any of the following is met:

✦ The purchaser has the ability or right to operate the asset(s) or direct others to operate the asset(s) while obtaining or controlling more than an insignificant amount of the output or other utility of the asset;
✦ The purchaser has the ability or right to control physical access to the underlying asset(s); or
✦ Facts and circumstances indicate that it is unlikely that one or more parties other than the purchaser will take more than an insignificant amount of the output, and the price the purchaser will pay is neither contractually fixed per unit nor equal to the current market price as of the time of delivery of the output.

Consider this second example: The gas supplier enters into an agreement to sell 75% of its output to a Thai production company while the remaining 25% will be sold to other industrial companies.

In this case, the Thai production company does not utilise the full capacity of supplier's facility; therefore, this agreement may not be considered as or contain a lease arrangement.

How does this affect your company? TFRIC 4 will produce changes to the way companies have historically presented items, such as property, on both the statement of financial position and on the income statement. When an arrangement is made within the scope of TFRIC 4, cash flows must be separated into their respective components, such as the right to use an asset, service or maintenance agreements and fuel supply.

The payments for the right to use the asset are accounted for as a "lease", including classification of the right of use as either an "operating lease" or a "finance lease". The accounting for the other components is in accordance with the relevant accounting standards.

If an arrangement contains an operating lease, the specific asset leased remains on the statement of financial position of the supplier. However, operating lease payments are recognised on a straight-line basis over the life of the lease. If an arrangement contains a finance lease, the asset is recorded on the statement of financial position of the purchaser and not the supplier. The supplier recognises a lease receivable on the statement of financial position and the finance income in the income statement.

As this will generally have a significant impact on your financial statements, Thai companies should re-examine their arrangements to determine if any contain leases as defined by TFRIC 4.

However in May 2013, the International Accounting Standards Board and the Financial Accounting Standards Board issued a revised Leases Exposure Draft (ED). Many observers believe the existing accounting standard for an operating lease is inconsistent with the conceptual frameworks. The existing model allows lessees to structure lease transactions to comply with an operating lease classification, and therefore benefit from off-balance sheet financing. Consequently, the board has developed a new approach that would require assets and liabilities arising from a lease to be recognised in the statement of financial position.

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Additionally, the scope of the ED includes leases contained with other arrangements. Existing guidance on when arrangements are, or contain, leases is included in IFRIC 4 (on which TFRIC 4 is based); similar guidance was carried forward into the ED. The ED defines a lease as "a contract that conveys the right to use an identifiable asset for a period of time in exchange for consideration". The legal form does not matter; a lease can be embedded in an arrangement such as a service contract. This requires assessing whether:

a) fulfilment of the contract depends on the use of an identifiable asset; and

b) the contract conveys the right to control the use of the identifiable asset for a period of time.

For the first condition, the Board decided to retain the requirement that fulfilment of the contract must depend on a specified or identified asset. Considering the second condition, it changed the proposed application guidance for "the right to control the use of asset" to be more consistent with the concept of control applied in other requirements.

Under the existing requirements in IFRIC 4, a customer can have the right to control the use of an asset on the basis of obtaining substantially all of the output from an asset, assuming that the contract is priced in a particular way. This describes "control" based on a "benefits" element only. The Board decided that such a customer must also have the ability to direct the use of the asset (a "power" element).

The notion of control in the proposed guidance could change prevailing accounting practice in some arrangements. Consequently, great care is needed when assessing a "power" element.

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