Accounting (Basics) - Lecture 5

Lease

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Classification of leases

- A lease is classified as **a finance lease** if it **transfers substantially all the risks and rewards incidental to ownership**. A lease is classified as **an operating lease** if it **does not transfer substantially all the risks and rewards incidental to ownership**.
- Whether a lease is a finance lease or an operating lease depends on the **substance of the transaction rather than the form of the contract.** Examples of situations that individually or in combination would normally lead to a lease being classified as **a finance lease are:**
  a) the **lease transfers ownership** of the asset to the lessee **by the end of the lease term.**
  b) 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.

Classification of leases

c) the **lease term** is for the **major part of the economic life of the asset** even if title is not transferred.

d) 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.**

e) **gains or losses** from the **fluctuation in the residual value of the leased asset** accrue **to the lessee** (e.g. in the form of a rent rebate equaling most of the sales proceeds at the end of the lease).

f) the lessee has the **ability to continue the lease for a secondary period at a rent** that is substantially **lower than market rent.**

Classification of leases

- These examples and indicators are not always conclusive. If it is clear from other features that the **lease does not transfer substantially all risks and rewards** incidental to ownership, the lease is classified as **an operating lease**.
- **Lease classification is made at the inception** of the lease and **is not changed during the term of the lease** unless the lessee and the lessor agree to change the provisions of the lease (other than simply by renewing the lease), in which case the lease classification shall be re-evaluated.

Finance leases - financial statements of lessees

- At the commencement of the lease term, **a lessee** shall **recognize its rights of use and obligations** under finance leases **as assets and liabilities in its statement of financial position** at amounts equal to **the fair value of the leased property or, if lower, the present value of the minimum lease payments**, determined at the inception of the lease. **Any initial direct costs of the lessee are added to the amount recognized as an asset**. The **present value of the minimum lease payments** should be calculated using the **interest rate implicit** in the lease. If this cannot be determined, lessee's **incremental borrowing rate** shall be used.
- A lessee shall **apportion minimum lease payments between the finance charge and the reduction of the outstanding liability** using the **effective interest method.**
- A lessee shall **depreciate an asset leased** under a finance lease in accordance with the relevant section of this IFRS for that type of asset. If there is **no reasonable certainty that the lessee will obtain**

Finance leases - financial statements of lessees

ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life. A lessee shall also **assess** at each reporting date **whether an asset leased under a finance lease is impaired.**

- A lessee shall make the following **disclosures for finance leases**:
  a) for each class of asset, the **net carrying amount** at the end of the reporting period.
  b) the **total of future minimum lease payments** at the end of the reporting period
  c) a general **description of the lessee's significant leasing arrangements** including, for example, information about contingent rent, renewal or purchase options and restrictions imposed by lease arrangements.

Finance leases - financial statements of lessors

- A lessor shall recognize **assets held under a finance lease in their statements of financial position and present them as a receivable at an amount equal to the net investment in the lease**. The **net investment in a lease** is the lessor's **gross investment in the lease discounted at the interest rate implicit in the lease.** The gross investment in the lease is the **aggregate of the minimum lease payments receivable** by the lessor under a finance lease, **and any unguaranteed residual value** accruing to the lessor.
- **For finance leases other than those involving manufacturer or dealer 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.
- The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. **Lease payments relating to the period, excluding costs for services, are applied against**

Finance leases - financial statements of lessors

the gross investment in the lease to reduce both the principal and the unearned finance income. If there is an indication that the **estimated unguaranteed residual value used in computing the lessor's gross investment in the lease has changed significantly**, **the income allocation over the lease term is revised**, and **any reduction in respect of amounts accrued is recognized immediately in profit or loss.**

- **A finance lease of an asset by a manufacturer or dealer** lessor gives rise to **two types of income**:
  a) **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
  b) **finance income over the lease term**.

Finance leases - financial statements of lessors

- **The sales revenue recognized** at the commencement of the lease term by a manufacturer or dealer lessor is **the fair value of the asset or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest.** The **cost of sale** recognized at the commencement of the lease term is the **cost, or carrying amount if different, of the leased property less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit**. **Costs incurred** by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be **recognized as an expense** when the selling profit is recognized.
- A lessor shall make the following **disclosures for finance leases:**
  a) a **reconciliation between the gross investment in the lease** at the end of the reporting period, and the **present value of minimum lease payments receivable** at the end of the reporting period. In addition, a lessor shall disclose the

Finance leases - financial statements of lessors

gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period

b) **unearned finance income**.

c) the **unguaranteed residual values** accruing to the benefit of the lessor.

d) the **accumulated allowance for uncollectible minimum lease payments receivable.**

e) **contingent rents** recognized as income in the period.

f) a general **description of the lessor's significant leasing arrangements**, including, for example, information about contingent rent, renewal or purchase options, restrictions imposed by lease arrangements.

Operating leases - financial statements of lessees

- A lessee shall recognize **lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless either:**
  a) **another systematic basis is representative** of the time pattern of the user's benefit, even if the payments are not on that basis, **or**
  b) **the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases**. If payments to the lessor vary because of factors other than general inflation, then this condition (b) is not met.
- A lessee shall make the following **disclosures for operating leases**:
  a) the **total of future minimum lease payments** under non-cancellable operating leases

Operating leases - financial statements of lessees

b) **lease payments recognized as an expense.**

c) a general **description of the lessee’s significant leasing arrangements** including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

Operating leases - financial statements of lessors

- A lessor shall present **assets subject to operating leases in its statement of financial position according to the nature of the asset.**
- A lessor shall **recognize lease income from operating leases (excluding amounts for services such as insurance and maintenance) in profit or loss on a straight-line basis over the lease term, unless either**
  a) **another systematic basis is representative** of the time pattern of the lessee’s benefit from the leased asset, even if the receipt of payments is not on that basis, or
  b) the **payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor’s expected inflationary cost increases.** If payments to the lessor vary according to factors other than inflation, then condition (b) is not met.

Operating leases - financial statements of lessors

- A lessor shall **recognize as an expense costs, including depreciation, incurred in earning the lease income**. The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets.
- To **determine whether a leased asset has become impaired**, a lessor shall apply Section "Impairment of Assers".
- **A manufacturer or dealer lessor does not recognize any selling profit on entering into an operating lease because it is not the equivalent of a sale.**
- A lessor shall **disclose** the following for **operating leases:**
  a) the **future minimum lease payments** under non-cancellable operating leases

Operating leases - financial statements of lessors

b) **total contingent rents recognized as income**.

c) a general **description of the lessor's significant leasing arrangements**, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, and restrictions imposed by lease arrangements.

Sale and leaseback transactions

- **A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset.** The lease payment and the sale price **are usually interdependent** because **they are negotiated as a package.** The accounting treatment of a sale and leaseback transaction depends on the type of lease:
  a) if a **sale and leaseback transaction results in a finance lease** - the **seller-lessee shall not recognize immediately**, **as income**, any excess of sales proceeds over the carrying amount. Instead**, the seller-lessee shall defer such excess and amortize it over the lease term.**
  b) if a **sale and leaseback transaction results in an operating lease** and **it is clear that the transaction is established at fair value** - the **seller-lessee shall recognize any profit or loss immediately. If the sale price is below fair value**, the **seller-lessee shall recognize any profit or loss immediately unless the loss is compensated for by future lease payments**

Sale and leaseback transactions

at below market price. In that case the **seller-lessee shall defer and amortize such loss in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the seller-lessee shall defer the excess over fair value and amortize it over the period for which the asset is expected to be used.**

- **Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions**. The required description of **significant leasing arrangements** includes description of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.