

## LEASES: ASPE 3065

### Scope

The following items are not covered under this section:

- licensing agreements for items such as motion pictures, videotapes, plays, manuscripts, patents and copyrights

### Definitions

- **Capital lease** is a lease that transfers substantially all the benefits and risks incident to ownership of property to the lessee
- **Operating lease** is a lease in which the lessor does not transfer substantially all the benefits and risks incident to ownership of property
- **interest rate implicit in the lease** is such that the FV of leased asset = PV of (Minimum Lease Payments + unguaranteed Residual value)
- **executory costs** = costs related to operating leased asset (insurance, maintenance, property tax)

### Classification

- A lease is classified as:
  - from the point of view of the lessee — capital or operating leases; and
  - from the point of view of the lessor — sales-type, direct financing or operating leases

### Lessee's criteria

- From the point of view of a **lessee**, a lease is a capital lease when one of the following is met:
  1. There is reasonable assurance that the lessee will **obtain ownership** of the leased asset by the end of the lease term
    - i. **ownership being transferred** to the lessee by the end of the lease term or
    - ii. when the lease provides for a **bargain purchase option (BPO)**
  2. the lease term is equal to a major portion (usually **75 percent or more**) of the economic life of the leased property
  3. present value, at the beginning of the lease term, of the minimum lease payments, excluding any portion relating to executory costs, is equal to substantially all (usually **90 percent or more**) of the fair value of the leased property,
    - i. the discount rate used by the lessee is the **lower of the**
      1. lessee's rate for incremental borrowing and
      2. the interest rate implicit in the lease, if known

### Lessor's criteria

- From the point of view of a **lessor**, a lease is a capital lease when the following are met
  1. any one of the **3 conditions above**
  2. the **credit risk** associated with the lease is normal
  3. any **unreimbursable costs** that are likely to be incurred by the lessor under the lease can be **reasonably estimated**
- A capital lease is accounted for as a sales-type lease or direct-financing lease by the lessor
  - **Sales type lease** = when the lessor is a manufacturer or dealer and when the fair value of the leased property is greater or less than the carrying amount (i.e. car dealerships)
  - **Direct financing lease** = when the lessor is not a manufacturer or dealer and when then the fair value of the leased property = carrying amount (when a lessor acts as a financing intermediary between a manufacturer or dealer and a lessee)

## Accounting treatment by a lessee

### Accounting for capital lease by lessee

- A capital lease is accounted for as an asset and a liability at the **lower of**:
  - a) **Fair value** of the leased property; or
  - b) The present value of the minimum lease payments (MLP)
    - The discount rate to use in the present value = **lower of incremental borrowing rate and the rate implicit in the lease**

### Minimum lease payments (MLP) for the lessee

- **The minimum lease payments** = rental payments + residual value guaranteed (partial or full) by the lessee or a third party related to the lessee + bargain purchase option
- **Contingent rent is excluded from MLP**

### Subsequent measurement

- The capitalized value of a PPE is to be **amortized**
  - If there is a **BPO or ownership transfer** at the end of the lease, amortize over the **useful life** of the asset
  - Otherwise amortize over **lease term**
- The lease liability is just like a loan; therefore, lease payments are allocated between:
  - interest
  - principal (reduction to liability); and
  - executory costs

### Accounting for operating lease by the lessee

- **operating leases** are recognized in **expense** over a **straight line basis** over the lease term (even if not payable in a straight line manner)
- **lease expense per term** = net lease payments over lease ÷ lease terms
  - any difference between lease expense and cash payment is recognized as an asset or liability
  - **net lease payments = total lease payments – lease inducements**
- **lease inducements** are inseparable from the lease; and are treated as a reduction to the expense recognized per term

## Accounting treatment by a lessor

### Accounting for Direct Financing Lease by Lessor

- **the lessor recognizes**
  - **gross receivable** = the minimum lease payments (excluding executory costs) + any unguaranteed residual value
  - **deferred financing income** = gross receivable – book value of asset leased
- **initial direct costs** = costs to arrange/negotiate lease (commission, legal fees)
- for **direct finance leases**, the **initial direct costs** are expensed when incurred; and portion of deferred finance income is brought into income at the same time (no effect on P&L)
  - Dr. Initial legal expense.....\$500
    - Cr. Cash .....500
  - Dr. Deferred finance income.....\$500
    - Cr. Income.....500

**Accounting for Sales Type Lease by Lessor**

- the lessor recognizes
  - **gross receivable** = the minimum lease payments (excluding executory costs) + any unguaranteed residual value
  - the lessor will have a **deferred financing income** = gross receivable – PV of the gross receivable
  - **Sales revenue** = PV of MLP (excluding executory costs) @ rate implicit in the lease
  - **Cost of goods sold** = book value of the leased asset **less** PV of unguaranteed residual value
- **Initial direct costs** are expensed at the inception of the lease

**Sample journal entries for lessor**

- Direct Finance Lease vs. Sales Type Lease
  - Annual payment = 10,000 per year for 10 yrs.
  - RV=5,000
  - PV (annual PMT) = 80,000
  - PV (RV) =1,000
  - BV of leased PPE = 50,000
  - FV of the leased asset = 81,000

**Case 1: If residual value is unguaranteed**

	Direct Financing Lease	Sales Type Lease
<b>Gross receivable (dr.)</b>	10,000*10 + 5,000=105,000	10,000*10 + 5,000=105,000
<b>Deferred Finance Income (cr.)</b>	= 105,000-81,000=24,000	= 105,000-81,000=24,000
<b>Credit entry</b>	FV of Asset Leased = PV (annual pmt, RV) = 81,000	Sales = PV (MLP) = 80,000
<b>Debit entry</b>		COGS=BV of leased asset - PV(ungur. RV)= 50,000-1,000=49,000

Direct Financing Lease	Sales Type Lease
Dr. Gross investment.....105K Cr. Deferred finance income.....24K Cr. Leased asset.....81K	Dr. Gross investment.....105K Dr. Cost of goods sold.....49K Cr. Deferred finance income.....24K Cr. Inventory.....50K Cr. Sales.....80K

**Case 2: If residual value is guaranteed**

	Direct Financing Lease	Sales Type Lease
<b>Gross receivable (dr.)</b>	10,000*10 + 5,000=105,000	10,000*10 + 5,000=105,000

<b>Deferred Finance Income (cr.)</b>	= 105,000-81,000=24,000	= 105,000-81,000=24,000
Credit entry	FV of Asset Leased = PV (annual pmt, RV) = 81,000	Sales = lower of: <ul style="list-style-type: none"> <li>• PV (MLP)= 81,000;</li> <li>• FV of leased Asset = 81,000</li> </ul>
Debit entry		COGS=BV of leased asset - PV(Ungur. RV)= 50,000-0=50,000

Direct Financing Lease	Sales Type Lease
Dr. Gross investment.....105K Cr. Deferred finance income.....24K Cr. Leased asset.....81K	Dr. Gross investment.....105K Dr. Cost of goods sold.....50K Cr. Deferred finance income.....24K Cr. Inventory.....50K Cr. Sales.....81K

### Accounting for Operating Lease by Lessor

- **operating leases** are recognized in **income** over a **straight line basis** over the lease term (even if not payable in a straight line manner)
- **lease income per term** = net lease receipts over lease ÷ lease terms
  - any difference between lease income and cash receipts is recognized as an asset or liability
  - **net lease receipts = total lease receipts – lease inducements**
- **initial direct costs** are capitalized as a separate asset and amortized over the lease term to income

### Subleases

- **subleases have no effect on the accounting for the original lease**
- if a sublease transfers all the benefits/risks of ownership related to the sub-leased asset (see criteria above) – then it is accounted for as a sales-type or direct financing lease; otherwise, it is accounted for as an operating lease

### Sale-leaseback transaction

- A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset
- The general theory under ASPE is that a sale and a lease are inseparable; and as a result the profit or loss from sale-leaseback transactions are deferred and amortized to income over lease term
- However, when the leaseback is a “portion” of the property sold, ASPE says that the sale and leaseback become separable; as a result a portion of the profit or loss can be recognized immediately
  - A portion can be the following:
    - Part of a property (i.e. sold office building and leased back 1 floor)
    - Portion of the asset’s remaining useful life

### Sale-Leaseback: Operating Leases

- When a seller-lessee leases back only a **minor portion** of the asset sold, the **entire gain or loss** from the sale is recognized in income at the **date of sale**
  - Use **judgement** in determining what constitutes “minor portion” (i.e. 1 floor leased back of a 20 floor building)
  - In addition, ASPE says that, if the **PV of the MLP is  $\leq$  10% of the FV of the asset sold**; the lessee is deemed to have only leased back a minor portion and the full profit on the sale is recognized immediately
- When the seller-lessee leases back **more than a minor portion but less than substantially all of the asset**; the gain from the sale recognized in income = gain from sale **less** the PV of the MLP
  - Again use judgement
  - This usually occurs when the PV MLP is between 11% to 89% of the FV of the asset
- When the seller-lessee lease back **substantially all of the asset**; the gain or loss from the sale is **deferred and amortized** to income over the **lease term**
- When at the time of sale-lease back of the **FV of the asset < book value of asset**; the difference is recognized as a **loss immediately**

### Sale-Leaseback: Capital Leases

- When a seller-lessee leases back only a **minor portion** of the asset sold, the **entire gain or loss** from the sale is recognized in income at the **date of sale**
  - Use **judgement** in determining what constitutes “minor portion” (i.e. 1 floor leased back of a 20 floor building)
  - In addition, ASPE says that, if the **PV of the MLP is  $\leq$  10% of the FV of the asset sold**; the lessee is deemed to have only leased back a minor portion and the full profit on the sale is recognized immediately
- When the seller-lessee leases back **more than a minor portion but less than substantially all of the asset**; the gain from the sale recognized in income = gain from sale **less** the recorded amount of the leased back asset (usually the PV of MLP)
  - Again use judgement
  - This usually occurs when the PV MLP is between 11% to 89% of the FV of the asset
- When the seller-lessee lease back **substantially all of the asset**; the gain or loss from the sale is **deferred and amortized** to income over the **useful life of the asset** (if land amortize over lease term)
- When at the time of sale-lease back of the **FV of the asset < book value of asset**; the difference is recognized as a **loss immediately**

### Leases involving land and buildings

- For a **capital lease** involving both a land and building component, only **capitalize the land separately** from the building if there will be a **change in ownership** or a **bargain purchase option** @ the end of the lease
  - Allocate the minimum lease payments to the land and building component with respect to the relative fair values of the land and building
- When **no change in ownership or BPO**, and when the **FV of the land is minor** compared to the FV of the total property, treat the land and building as a **single unit** for classification
- When **no change in ownership or BPO**, and when the **FV of the land is significant** compared to the FV of the total property, you need to separately capitalize the land and building

- Allocate the minimum lease payments to the land and building component with respect to the relative fair values of the land and building

### Comparison with IFRS

- Leases are covered under IAS 17
- The **terminology** is different; a **finance lease** is called **capital lease**
- Under IFRS, the **criteria** to classify a lease as a finance lease is less defined (for instance it doesn't say the present value of the minimum lease payments must be  $\geq 90\%$  of the fair market value)
- Under IFRS, **secondary conditions** are mentioned for classifying a lease as a finance lease
- Under IFRS, for a **lease with a land and building** –
  - you do always need to split the land and the building unless the FV of the land is minor
  - the minimum lease payments are allocated based on the relative fair values of the leasehold interest attributable to land/building as opposed to the relative fair values of the physical land and building
- under IFRS, the minimum lease payments is discounted at the **rate implicit in the lease** (only when this is not known, we use the borrowing rate)
- under IFRS, **initial direct costs** are only mentioned for both lessees and lessors; initial direct costs are handled differently (please see notes)
- under IFRS, **executor costs** are called **costs for services and taxes to be paid by and reimbursed to the lessor** and are also excluded from the MLP
- under IFRS, manufacturer/dealer leases are called **sales type lease**
- under IFRS, accounting sales and lease back transactions is different