LEASES: IAS 17

Scope

This section does not apply to the following:

- Investment properties held by lessees (finance or operating) that are accounted for as an investment property (see IAS 40)
- Investment propertied provided by lessors under operating leases
- Biological assets held by lessees under a finance lease
- Biological assets provided by lessors under an operating lease
- Licencing agreements (motion pictures, plays, manuscripts, patents, copyrights)

Definition

- 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.
- An **operating lease** is a lease other than a finance lease
- **interest rate implicit in the lease** is such that the FV of leased asset + initial direct costs = PV of (Minimum Lease Payments + unguaranteed Residual value)

Classification of leases

- The classification of lease (as finance or operating) is determined on the **date of inception**
- **Date of inception** = earlier **of date of lease agreement** and the **date of commitment** by the parties to the lease
- The lease is recognized in the books on the **commencement of the lease term**
- **Commencement of the lease term** = the date when the lessee has the right to use the asset

A lease with both land and buildings elements

- When a lease includes both land and a building together, you need to assess each element separately using the criteria below to determine if it is a finance lease or operating lease
- An important thing to consider is that land has an indefinite life (this may lead to the conclusion that land element is an operating lease)
- The minimum lease payments are allocated between the land and the building in proportion to the relative **fair value of the lease** attributable to the land and building
    - If the lease payments **cannot be allocated reliably** between the land and the building, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases
    - Note that the relative fair value of the lease attributable to land and building is not the same as the relative fair value of the physical land and building
    - Fair value of the lease is the present value of the benefits we are expecting to get from the leased land and building
- If the amount recognized for the **land** (lower of FV or the present value of MLP) is **immaterial**, the land and the building may be treated as a single unit

Finance Lease

- A lease is classified as a finance lease if it **transfers substantially all the risks and rewards** incidental to ownership
- A lease is a finance lease if **any one** of the following conditions are met:
    1) the lease **transfers ownership** of the asset to the lessee by the **end** of the lease term

2) 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**
3) the lease term is for the **major part of the economic life** of the asset even if title is not transferred
4) 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
5) the leased assets are of such a **specialised nature** that only the lessee can use them **without major modifications**

- **secondary factors that could also lead to a lease being classified as a finance lease are:**
    1) if the lessee can cancel the lease, the **lessor's losses associated with the cancellation are borne by the lessee**;
    2) **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
    3) the lessee has the ability to continue the lease for a **secondary period at a rent that is substantially lower than market rent**
- under IFRS, judgement is required to determine what constitutes a major part of the economic life and what constitutes substantially all of the fair market value
- these above 8 **criteria are not conclusive**; if other factors indicate that substantially all the risks and rewards have not been transferred, the lease will not be classified as a finance lease

Leases in the financial statements of lessees

Finance Lease

- At the commencement of the lease term, the lessee should recognize a finance lease as an asset and a liability on the balance sheet 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 = **interest implicit in the lease**
        - If the interest implicit in the lease is **not determinable** use the lessee's **incremental borrowing rate**
- **Initial direct costs of the lease** (i.e. cost of negotiating/arranging lease) are added to the amount of asset recognized

Minimum lease payments (MLP) of the Lessee

- Minimum lease payments for lessee **include** the following:
    - Minimum lease **payments = the payments over the lease term that the lessee is required to make** + amounts **guaranteed by the lessee** or by a party related to the lessee + **bargain purchase options**
    - **Lease incentives are also included in the MLP**
- Minimum lease payments **exclude** the following:
    - contingent rent + costs for services and taxes to be paid by and reimbursed to the lessor

Subsequent Measurement

- the minimum lease payments are allocated between **principal** (reduction to the lease liability) and **interest**
- **contingent rent** is expensed when it is incurred
- the asset recorded under a finance lease by the lessee must be **amortized**

  - if the lessee is **not reasonably certain** that he/she will obtain ownership @ the end of the lease – amortize over the **shorter of lease term and useful life**
  - if the lessee is **reasonably certain** that he/she will obtain ownership @ the end of the lease – amortize **over the useful life**
  - note you can obtain ownership via a bargain purchase option also

Operating leases

- lease payments for an operating lease is **expensed** on a straight line basis
- **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 (see lease incentives notes SIC 15)

Leases in the financial statements of lessors

Finance Lease

- For a finance lease, lessors **recognize an asset** and present this as a receivable equal to the **net investment in the lease**
- **Net investment in the lease** = **present value of the gross investment** in the lease discounted @ the interest rate implicit in the lease
- **Gross investment in the lease** = total **minimum lease payments** receivable by the lessor over the lease + and **unguaranteed residual value**
- **Deferred finance income (this represents the interest) =** gross investment – net investment
- Please see below for sample journal entry
- **Initial direct costs** are often incurred by lessors and include amounts such as commissions, legal fees and internal costs to negotiate and arrange a lease
- 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
- For a manufacturer/dealer lessor, initial direct costs are expensed

Minimum lease payments for lessors

- Minimum lease payments for lessors = **the payments over the lease term that the lessee is required to make** + residual value **guaranteed by the lessee** or by a party related to the lessee or a third party unrelated to the lessee + **bargain purchase options**
- Minimum lease payments **exclude** the following:
  - contingent rent + costs for services and taxes to be paid by and reimbursed to the lessor

Special Rule for Manufacturer and dealer lessors

- **Manufacturers or dealers** often offer to customers the choice of either buying or leasing an asset
- The manufacturer/dealer lessors will recognize 2 types of income
  - "sales revenue" and "cost of goods sold" initially; and
  - Interest income over the lease term
- **Sales revenue** = **lower of** (a) fair value of the asset and (b) the present value of the minimum lease payments computed at the market interest rate
  - The reason why IFRS does this is because, it doesn't want lessors to quote artificially low implicit rates in the lease to overstate sales revenue
  - Remember PV of the MLP using rate implicit in the lease = Fair Value
- **Cost of goods sold** = carrying amount of the leased property (i.e. the inventory) **less** the PV of **unguaranteed** residual value

- To understand this better please see the journal entries below

Sample journal entries for lessor

- Financing Type Lease vs. Manufacturer/Dealer 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

	Financing Type Lease	**manufacturer/dealer lease**
Gross receivable (dr.)	10,000*10 + 5,000=105,000	10,000*10 + 5,000=105,000
Deferred Finance Income (cr.)	= 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: 1. PV (MLP) = 80,000; 2. FV of leased Asset = 81,000
Debit entry		COGS=BV of leased asset - PV(ungur. RV)= 50,000-1,000=49,000

Financing Type Lease	**manufacturer/dealer 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

	Financing Type Lease	**manufacturer/dealer lease**
Gross receivable (dr.)	10,000*10 + 5,000=105,000	10,000*10 + 5,000=105,000
Deferred Finance Income (cr.)	= 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: • PV (MLP)= 81,000; • FV of leased Asset = 81,000
Debit entry		COGS=BV of leased asset - PV(Ungur. RV)= 50,000-0=50,000

Financing Type Lease	**manufacturer/dealer 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

Operating leases

- Income from operating leases are recognized in income over a **straight lines basis**
    - **Income recognized per term=** net lease payments over the lease term ÷ lease term
- **Initial direct costs** on an operating lease are added to the carrying value of the leased asset and amortized to expense over the lease term

Sale and leaseback transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset

Sale-Leaseback: Operating Lease

If the transaction is **established at fair value**	any profit or loss shall be recognised **immediately**
If the **sale price is below fair value**	any profit or loss shall be recognised **immediately except** if the **loss is compensated for by future lease payments at below market price**, it is **deferred and amortised** over the period for which the **asset is expected to be used**
If the **sale price is above fair value**	the **excess over fair value** is **deferred and amortised** over the period for which the **asset is expected to be used** **the fair value less carrying value** is recognized immediately
if the fair value at the time of a sale and leaseback is less than the carrying amount of the asset	**loss** = carrying amount less fair value shall be recognised **immediately**

Sale-Leaseback: Finance Lease

- If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount is **not immediately recognised as** income by a seller-lessee.
- Instead, it is **deferred and amortised** over the **lease term**

Advanced topic: Investment property held under an operating lease by lessee

- under IAS 40, the lessee has the option to treat an investment property held under an operating lease as an investment property (i.e. say it subleases the property)
- when this is done, the lease is automatically treated as a finance lease, and per IAS 40, the fair value model MUST be used
- this classification/measurement is held intact, even if the property ceases to be an investment property in the future

Comparison with ASPE

- Leases are covered under ASPE 3065
- The **terminology** is different; a **finance lease** is **called capital lease**
- Under ASPE, the **criteria** to classify a lease as a capital lease is more defined (for instance the present value of the minimum lease payments must be ≥90% of the fair market value)
- Under ASPE, the **secondary conditions** mentioned in IFRS are not mentioned
- Under ASPE, for a **lease with a land and building** –
    - Under ASPE, you do not need to split the land and the building unless
        - Ownership transfers @ end of lease or there is a bargain purchase option; or
        - Fair value of the land is major in relation to the fair value of the leased property
    - the land will be considered a capital lease only if the title passes at the end of the lease of if there is a bargain purchase option
    - the minimum lease payments are allocated based on the relative fair values of the physical land and building as opposed to the relative fair values of the lease attributable to the land/building
- under ASPE, the minimum lease payments is discounted at the **lower of the borrowing rate or the rate implicit in the lease**
- under ASPE, **initial direct costs** are only mentioned for lessors; initial direct costs are expensed and an equal amount will be charged to revenue (therefore no impact on net income)
- under ASPE, **costs for services and taxes to be paid by and reimbursed to the lessor** is called **executor costs** and are also excluded from the MLP
- under ASPE, manufacturer/dealer leases are called **sales type lease**
- under ASPE, initial direct costs from an operating lease are recognized as a separate asset and amortized to expense over lease term
- under ASPE, accounting sales and lease back transactions is different