

# CHAPTER 20

## LEASES

### CHAPTER TOPICS CROSS REFERENCED WITH *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Leases

IAS 17

Section 3065

## LEARNING OBJECTIVES

1. Understand the importance of leases from a business perspective.
2. Explain the conceptual nature, economic substance, and advantages of lease transactions.
3. Identify and apply the criteria that are used to determine the type of lease for accounting purposes for a lessee under the classification approach.
4. Calculate the lease payment that is required for a lessor to earn a specific return.
5. Account for a lessee's basic capital (finance) lease.
6. Determine the effect of, and account for, residual values and bargain purchase options in a lessee's capital (finance) lease.
7. Account for an operating lease by a lessee and compare the operating and capitalization methods of accounting for leases.
8. Determine the statement of financial position presentation of a capital (finance) lease and identify other disclosures required.
9. Identify and apply the criteria that are used to determine the type of lease for a lessor under the classification approach.
10. Account for and report basic financing and sales-type leases by the lessors.
11. Account for and report financing and sales-type leases with guaranteed values or a bargain purchase option by a lessor.
12. Account for and report an operating lease by a lessor.
13. Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.
14. Describe and apply the lessee's accounting for sale-leaseback transactions. (Appendix 20A)
15. Explain the classification and accounting treatment accorded leases that involve real estate. (Appendix 20A)
16. Explain and apply the contract-based approach to a basic lease for a lessee and lessor.

# CHAPTER REVIEW

## *Basic Concepts*

1. Many businesses lease substantial portions of the property and equipment they use in their business organization as an alternative to ownership. Because leasing provides some financial, operating, and risk advantages over ownership, it has become the fastest growing form of capital investment. This increased significance of lease arrangements in recent years has intensified the need for uniform accounting and complete informative reporting of leasing transactions. Chapter 20 presents a discussion of the accounting issues related to leasing arrangements from the point of view of **both the lessee and the lessor**. Among the issues discussed are: (a) the classification of leasing arrangements, (b) the various methods used in accounting for leases, and (c) the financial statement disclosure requirements when leases are present.
2. A **lease** is a contractual agreement between a **lessor** and a **lessee** that conveys to the lessee the right to use specific property (real or personal) owned by the lessor, for a specified period of time. In return for this right, the lessee agrees to make periodic cash payments (**rents**) to the lessor. An essential element of the lease conveyance is that the lessor conveys less than his/her total interest in the property.
3. The particulars of a lease arrangement are dependent upon the agreement entered into by the lessee and lessor. Most lease contracts include provisions related to (a) the duration of the lease, (b) the amount of periodic rental payments, (c) the party required to pay taxes, insurance, and maintenance, (d) the restrictions imposed on parties to the lease, (e) the cancellation terms, (f) default provisions, and (g) the alternatives of the lessee at the time of lease termination. The manner in which these various provisions are used in the lease agreement aids in determining the accounting methods used to properly portray the substance of each situation.

## *Advantages of Leasing*

1. In discussing the advantages of leasing arrangements, advocates point out that leasing allows for **(a) 100% financing; (b) protection against obsolescence; (c) less costly financing for lessee, tax incentive for lessor; (d) flexibility; and (e) off-balance sheet financing.**
2. A variety of opinions exist regarding the manner in which certain long-term lease arrangements should be accounted for. These opinions range from total capitalization of all long-term leases (contract-based approach) to the belief that leases represent executory contracts that should not be capitalized. The classification approach can be characterized as advocating capitalization of lease arrangements that are similar to instalment purchases. In short, lease

arrangements that transfer substantially all of the risks and rewards of ownership of property should be capitalized by the lessee.

### **Classification Approach — Lessees**

1. For accounting purposes of the **lessee**, all leases may be classified as **operating leases** or **finance (capital) leases**. When all the risks and benefits of ownership are transferred from the lessor to the lessee, the lessee should classify and account for an arrangement as a capital lease under ASPE if **one or more** of the following criteria are met on the date of the lease agreement.
  - a. The lease transfers ownership of the property to the lessee or the lease contains a bargain purchase option.
  - b. The lease term is equal to 75% or more of the estimated economic life of the leased property.
  - c. The present value of the minimum lease payments (excluding executory costs) equals or exceeds 90% of the fair value of the leased property.

All leases that fail to meet **at least one** of the three criteria above are classified and accounted for by the lessee as operating leases.

2. Similarly under IFRS, a lease that transfers substantially all the benefits and risks of property ownership should be capitalized. Any one or a combination of the following would normally indicate this transfer of benefits and risks has occurred:
  - a. There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. If there is a bargain purchase option in the lease, it is assumed that the lessee will exercise it and obtain ownership of the asset.
  - b. The lease term is long enough that the lessee will receive substantially all of the economic benefits that are expected to be derived from using the leased property over its life.
  - c. The lease allows the lessor to recover substantially all of its investment in the leased property and to earn a return on the investment. Evidence of this is provided if the present value of the minimum lease payments is close to the fair value of the leased asset.
  - d. The leased assets are so specialized that, without major modification, they are of use only to the lessee.

3. For clarification of the above:  
**Transfer of ownership** test: Under IFRS and ASPE, the criteria is straightforward and easy to apply in practice. It will be evidenced by no additional payment or a **bargain purchase option**, a provision allowing the lessee to purchase the leased property for a price that is significantly lower than the property's expected fair value at the date the option becomes exercisable. In applying these criteria, it is

always assumed that the lessee will exercise a bargain purchase option, thereby transferring ownership of the leased asset by the end of the lease term.

**The economic life test:** Under **ASPE**, the economic life test is numerically determined based on the belief that when a lease period equals or exceeds 75% of the asset's economic life, the risks and rewards of ownership are transferred to the lessee and capitalization is appropriate. IFRS does not reference a 75% test, but rather requires applying judgement based on the lease term, renewal options, and the type of asset.

**The recovery of investment by lessor test:** The reason for the **90% of fair market value** required to pass this test is that if the present value of the minimum lease payments are reasonably close to the market price of the asset, the asset is effectively being purchased. In calculating the minimum lease payments, IFRS requires the interest rate implicit in the lease to be used whenever it is reasonably determinable, otherwise the incremental borrowing rate is used. ASPE specifies that the lower of the two rates is used.

### ***Finance Leases for Lessees***

1. Under the finance lease method the lessee treats the lease transactions as if an asset were being purchased on time (instalment basis). For a capital lease, the lessee records an asset and a liability at the lower of (a) the present value of the minimum lease payments during the term of the lease or (b) the fair value of the leased asset at the inception of the lease. In determining the present value of the minimum lease payments, three important concepts are involved: (a) minimum lease payments, (b) executory costs, and (c) the discount rate.
2. Minimum lease payments include (a) minimum rental payments, (b) any residual value guaranteed by the lessee, (c) penalty for failure to renew or extend the lease, and (d) any bargain purchase option. Minimum rental payments are the minimum payments the lessee is obligated to make to the lessor under the lease agreement. A guaranteed residual value is the estimated fair value of the leased property at the end of the lease term. This allows the lessor to transfer the risk of loss in the fair value of the asset to the lessee. The guaranteed residual value is (a) the amount at which the lessor has the right to require the lessee to purchase the asset or (b) the amount the lessee or third-party guarantor guarantees the lessor will receive.
3. **Executory costs** include the cost of insurance, maintenance, and property tax expense related to the leased asset. If the lessor makes these payments, such amounts should reduce the present value of the minimum lease payments to the extent the lessor recovers these through the lease payment. When the lease agreement specifies that executory costs are assumed by the lessee, the rental payments can be used without adjustment in the present value computation.

Under ASPE, the lessee uses its **incremental borrowing rate (discount rate)** to calculate the present value of minimum lease payments. However, if the lessee knows the **implicit rate computed by the lessor**, and that rate is **less** than the lessee's incremental borrowing rate, then the lessee must use the implicit rate.

Under IFRS, the interest rate implicit in the lease is used whenever it is reasonably determinable, otherwise the incremental borrowing rate is used.

### ***How the Lessor Determines the Rental Payments***

1. The lessor determines the rental payments based on the rate of return – the implicit rate – that the lessor needs to receive in order to justify leasing the asset. Key variables considered in setting the rate include the lessee's credit standing, the length of the lease, and the status of the residual value (guaranteed or unguaranteed)

### ***Accounting for a Finance (Capital) Lease***

1. When the lessee uses the finance lease method, each lease payment is allocated between a reduction of the lease obligation and interest expense applying the **effective interest method**. The lessee should depreciate the leased asset by applying one of the conventional depreciation methods. During the term of the lease, assets recorded under finance leases are separately identified in the lessee's statement of financial position. Likewise, the related obligations are separately identified with the portion due within one year or the operating cycle, whichever is longer, classified with current liabilities and the balance with non-current liabilities.
2. A complete illustration of the accounting for a finance lease by the lessee is found in the text. It is important to understand the preparation of the Lease Depreciation Schedule. This schedule provides the basis for the entire range of journal entries for the lease transaction. The basic entries include (a) initial capitalization which requires a debit to the asset and a credit to the liability, (b) annual lease payments which include a debit to the liability and a credit to cash, and (c) the annual depreciation entry. Of course, any interest accrual or executory costs would be included in the entries made for the lease obligation.

### ***Residual Value***

1. The **residual value** of a leased asset is the estimated fair value of the leased property at the end of the lease term. The residual value may be **guaranteed** or **unguaranteed** by the lessee. A guaranteed residual value is said to exist when the lessee agrees to make up any deficiency below a stated amount in the value of the asset at the end of the lease term. A guaranteed residual value affects the lessee's calculation of the minimum lease payments and, therefore, the amounts capitalized as a leased asset and a lease obligation. The lessor assumes the residual value will be realized at the end of the lease term whether guaranteed or unguaranteed.
2. **From the lessee's perspective, lease payments to be capitalized include the guaranteed residual value, but exclude an unguaranteed residual value.** To understand the accounting implications of a guaranteed residual value, assume a lessee guarantees the residual value of an asset to be \$8,000. If, at the end of the lease, the fair value of the asset is less than \$8,000, the lessee will have to make

up the difference, recording a loss. For example, if the lessee depreciated the asset down to its residual value of \$8,000 but the fair value of the asset was only \$5,000, the lessee would have to record a loss of \$3,000. If the asset's value exceeded \$8,000, a gain may be recognized, depending on the terms of the lease agreement.

### ***Bargain Purchase Option***

1. A **bargain purchase option** is a provision allowing the lessee, at his or her option, to purchase the leased property at a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable. **When a bargain purchase option exists, the lessee must increase the present value of the minimum lease payments by the present value of the option price.** The only difference between accounting for a bargain purchase option and a guaranteed residual value of identical amounts is in the calculation of the depreciation amount. In the case of a guaranteed residual value, the lessee depreciates the asset over the lease life, since the asset reverts to the lessor. When a bargain purchase option is present, the lessee uses the economic life of the asset **because title to the asset is expected to revert to the lessee.**

**Illustrations 20-4 to 20-16** in the text illustrate the accounting under several situations, including a bargain purchase option and residual values.

### ***Operating Leases for Lessees***

1. In accounting for an operating lease, the lessee would use the accounting method known as the **operating (non-capitalization) method**. When the lessee uses the operating method, the periodic rent associated with the lease is recognized in the period benefited by the leased asset. Under this method, the commitment to make future rental payments is not recognized in the accounts. Only note recognition is given to the commitment to pay future rentals. The journal entry the lessee would make to record operating lease payments includes a debit to rent expense and a credit to cash.

### ***Presentation and Disclosure of a Finance (Capital) Lease and Operating Lease***

1. Standards require that disclosures by the lessee for **finance (capital) leases** are those similar to other standards covering property, plant, and equipment, intangible assets, impairment, financial instruments, and/or long-term liabilities. However IFRS also requires additional disclosures related to:
  - a. The net carrying amount of each class of leased asset.
  - b. A reconciliation of the future minimum lease payments to their present value in total, and for the next year, years two to five, and beyond five years from the statement of financial position date.
  - c. The entity's material lease arrangements, especially concerning contingent rents, sublease payments, and restrictions imposed by lease agreements.

2. IFRS and ASPE require disclosure of the minimum lease payments for their operating leases at the statement of financial position date and those payable in each of the next five years. IFRS also require disclosures to include a description of significant lease arrangements and information about subleases and contingent rents.

### ***Classification Approach — Lessors***

1. For accounting purposes of the **lessor**, all leases may be classified as **(a) operating leases, (b) direct financing leases, or (c) sales-type leases**. Terminology under IFRS for the latter two leases are other finance lease and manufacturer or dealer lease respectively. The lessor should classify and account for an arrangement as a direct financing lease or a sales-type lease if at the date of the lease agreement based on the same criteria used by a lessee when classifying as a finance (capital) lease. However, under ASPE, two additional revenue recognition based tests must be passes as follows:
  - a. The credit risk associated with the lease is normal when compared to the risk of collection of similar receivables.
  - b. The amounts of any unreimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated.

All leases that fail to meet the aforementioned criteria are classified and accounted for by the lessor as operating leases.

### ***Accounting for Financing and Sales-Type Leases***

1. A lessor should account for an operating lease using the **operating method**. The distinction between a direct financing lease and a sales-type lease concerns the fact that a **sales-type lease involves a manufacturer's or dealer's profit (or loss) and a direct financing lease does not**. The primary difference between applying the financing method to a direct financing lease and applying it to a sales-type lease is the recognition of the manufacturer's or dealer's profit at the inception of the lease. The profit or loss to the lessor is evidenced by the difference between the fair value of the leased property at the inception of the lease and the lessor's cost or carrying amount (book value).
2. Under the **operating method**, each rental receipt of the lessor is recorded as rent revenue on the use of an item carried as a fixed asset. The fixed asset is depreciated in the normal manner, with the depreciation expense of the period being matched against the rental revenue.
3. Leases that are in substance the financing of an asset purchased by a lessee require the lessor to substitute a **lease payments receivable** for the leased asset. Lessor accounting under such a capital lease arrangement requires computation of (a) gross investment in the lease, (b) unearned interest revenue, and (c) net investment. The **gross investment in the lease** is equal to the sum of

(a) the minimum lease payments, and (b) the unguaranteed residual value accruing to the benefit of the lessor. The **net investment in the lease** is the present value of the gross investment or the gross investment (the receivable) less the unearned interest. **Unearned interest revenue**, represented by the difference between the gross investment in the lease recorded as the receivable and the cost or carrying value of the property, is depreciated to revenue over the lease term by use of the effective interest method. Any **contingent rentals**, including rentals based on variables such as prime interest rate or sales volume, are credited to income when they become receivable.

4. The text material includes a complete illustration of the accounting entries a lessor would make for a direct financing lease. Preparation of a lease depreciation schedule is an effective way to provide all the information necessary for the required journal entries.
5. Leases have certain characteristics that create unique accounting problems. These problems have been addressed in Section 3065 of the *CICA Handbook*, Part II (ASPE). The following paragraphs discuss these characteristics.
6. Under sales-type leases, **the profit recorded by the lessor at the point of sale is the same whether the residual value is guaranteed or not**, but the sales revenue and cost of goods sold amounts are different. The present value of the unguaranteed residual value is deducted from both sales and cost of goods sold.

### ***Initial Direct Costs***

1. **Initial direct costs** are the costs incurred by the lessor that are directly associated with negotiating and consummating a **completed** lease transaction such as commissions, legal fees, and costs of preparing and processing lease documents. These initial costs are treated somewhat differently under ASPE and IFRS but the resulting difference in reported income and assets is not material so this chapter does not look at the treatment of these costs specifically under each lease situation. Basically, they are accounted for similar to other costs in that the costs are matched with the revenue of the accounting period benefiting from the lease. There are two types of initial direct costs, incremental direct costs and internal direct costs. Incremental direct costs are costs incurred in originating a lease arrangement that are paid to third parties. Internal direct costs are costs directly related to specified activities performed by the lessor on a given lease. When an operating lease is present, we defer and depreciate the initial direct costs over the life of the lease in proportion to rental income. In a sales-type lease these costs are expensed in the period that profit on the sale is recognized. In a financing-type leases, initial direct costs are recognized in a manner that they are spread over the life of the lease.

### ***Lessor Disclosures***

1. The specific disclosure requirements required under ASPE related to a lessor's involvement in financing and sales-type lease agreements are limited to disclosure of the entity's net investment and the interest rate implicit in them, as

well as the carrying amount of any impaired leases. Under IFRS, more extensive disclosure is required, including a reconciliation between the gross investment in the lease, and the present value of the minimum lease payments, the amounts due within the next year, between years two to five, and beyond five years. Disclosure is also required on the amount of unearned finance income, unguaranteed residual values, contingent rental income in the year, and general information about the lessor's leasing arrangements. Disclosure is also required on operating leases under both ASPE and IFRS.

### ***IFRS/ASPE Comparison***

1. Refer to **Illustration 20-32** in the text which identifies the differences between ASPE and IFRS.

### ***Appendix 20A: Other Lease Issues***

1. A **sale-leaseback transaction** is one in which the owner of property sells it to another and simultaneously leases it back from the new owner. The lessee, in a sale-leaseback transaction, should apply the same criteria mentioned earlier in deciding whether to account for the lease as a finance (capital) lease or an operating lease. Likewise, the purchaser-lessor would apply the criteria mentioned earlier in deciding whether the sale-leaseback transaction should be accounted for using the operating method or the financing method. If classified as an operating lease, ASPE, the seller-lessee takes the deferred gain or loss into income in proportion to the rental payments made, whereas under IFRS the gain or loss can be taken into income immediately. If classified as a finance (capital) lease, the deferred gain or loss is taken into income over the same period/basis as the depreciation on the lease asset under ASPE and over the term of the lease under IFRS.
2. Leases that involve land, buildings or equipment are referred to as real estate leases. When the lease involves only land, it should be accounted for as an operating lease by the lessee, unless the ownership of the land is transferred to the lessee (under both ASPE and IFRS), or a bargain purchase options exists (applicable to ASPE only). If ownership transfers, the lessee accounts for the lease as a capital or finance lease and the lessor should account for the lease as a sales-type or direct financing lease, whichever is appropriate.
3. Under ASPE, when the lease involves land and buildings, the lessee may capitalize land separately when transfer of ownership occurs, either directly or through a bargain purchase option. The present value of the minimum lease payments is allocated between the land and buildings in proportion to their fair values at the inception of the lease. If title will not pass, the land and building may be treated as a single unit if the fair value of the land relative to the building is minor. If not, the land portion will be treated as an operating lease. Under IFRS, the minimum lease payments are allocated on the basis of the relative fair values of the leasehold interest in each component. If this can't be reliably determined, the entire lease is classified as a finance lease unless it is clear that both are financing leases. If the land portion is immaterial, it may be accounted for as a

single unit.

### **Appendix 20B: Contract-Based Approach**

1. The major difference between the contract-based approach and the classification approach is that the former sees the asset leased by the lessee as a contractual right to use the asset, not as a transfer of the asset itself. This approach could result in its scope. Many non-cancellable leases that would otherwise be classified as an operating lease would now require recognition of the contractual right to use the asset and the contractual obligation.

#### **Lessee**

1. **A. Initial Measurement:** Asset and liability recognized when lease contract signed, and the lease contractual right and obligation are usually equal. They would be reported net on the statement of financial position.
  - **Contractual Obligation:** Measured at the present value of the lease payments so need to consider contingent rentals, guarantees of residual values, renewal options (at a bargain or not), and the discount rate.
  - **Contractual Right-of Use Asset:** Measured initially at cost, based on the present value of the lease payments (which should equal the value assigned to the contractual obligation).
2. **B. Measurement after Recognition:** No longer reported net on the statement of financial position.
  - **Contractual obligation** is accounted for at amortized cost, reduced by lease payments with each payment separated into interest (based on original discount rate) and principal reduction. Estimates used in initial valuation (e.g., lease term) are re-assessed if circumstances indicate there may be a material change.
  - **Contractual Right-of-Use Asset:** Measured similar to an intangible asset – amortized to expense using a systematic basis (consistent with its use). Amortization expense, not rent expense is used to recognize the expense on the income statement. Also consistent with intangible assets, the right-of-use asset can be revalued using the revaluation model in IAS 38 *Intangible Assets* and considered for impairment under IAS 36 *Impairment of Assets*.

#### **Lessor**

1. **A. Initial Measurement:** Lease receivable (contractual rights) and performance obligation (liability) recognized when lease contract signed, and reported net on the statement of financial position until the asset is delivered and performance begins.
  - **Performance Obligation:** Measured at the present value of the lease payments that are also recognized in the lease receivable.
  - **Lease Receivable:** Measured at the present value of the rental payments to be received, discounted at the interest rate the lessor is charging the lessee, increased by any initial direct costs incurred by the lessor.

2. **B. Measurement after Recognition:**

- **Performance Obligation:** Obligation decreased as lessor meets performance obligation and amounts are transferred from the liability to revenue.
- **Lease Receivable:** Measured at amortized cost, using the effective interest method.