

RELEVANT TO ACCA QUALIFICATION PAPER F7

### Studying Paper F7?

Performance objectives 10 and 11 are relevant to this exam

## ACCOUNTING FOR LEASES

The accounting topic of leases is a popular Paper F7 exam area that could feature to varying degrees in Questions 2, 3, 4 or 5 of the exam. This topic area is currently covered by IAS 17, *Leases*. IAS 17, *Leases* takes the concept of **substance over form** and applies it to the specific accounting area of leases.

When applying this concept, it is often deemed necessary to account for the substance of a transaction, ie its commercial reality, rather than its strict legal form. In other words, the legal basis of a transaction can be used to hide the true nature of a transaction. It is argued that by applying substance, the financial statements become more reliable and ensure that the lease is faithfully represented.

### Why do we need to apply substance to a lease?

A lease agreement is a contract between two parties, the lessor and the lessee. The lessor is the legal owner of the asset, the lessee obtains the right to use the asset in return for rental payments.

Historically, assets that were used but not owned were not shown on the statement of financial position and therefore any associated liability was also left out of the statement – this was known as ‘off balance sheet’ finance and was a way that companies were able to keep their liabilities low, thus distorting gearing and other key financial ratios. This form of accounting did not faithfully represent the transaction. In reality a company often effectively ‘owned’ these assets and ‘owed a liability’.

Under modern day accounting the IASB framework states that an asset is ‘a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity’ and a liability is ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’. These substance-based definitions form the platform for IAS 17, *Leases*.

### So how does IAS 17 work?

IAS 17 states that there are two types of lease, a finance lease and an operating lease. The definitions of these leases are vital and could be required when preparing an answer in the exam.

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### ***Finance lease***

A finance lease is a lease that *transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee.*

### ***Operating lease***

An operating lease is defined as being *any lease other than a finance lease.*

### ***Classification of a lease***

In order to gain classification of the type of lease you are dealing with, you must first look at the information provided within the scenario and determine if the risks and rewards associated with owning the asset are with the lessee or the lessor. If the risks and rewards lie with the lessee then it is said to be a finance lease, if the lessee does not take on the risks and rewards, then the lease is said to be an operating lease.

### ***Finance lease indicators***

There are many risks and rewards outlined within the standard, but for the purpose of the Paper F7 exam there are several important areas. The main reward is where the lessee has the right to use the asset for most of, or all of, its useful economic life. The primary risks are where the lessee pays to insure, maintain and repair the asset.

When the risks and rewards remain with the lessee, the substance is such that even though the lessee is not the legal owner of the asset, the commercial reality is that they have acquired an asset with finance from the leasing company and, therefore, an asset and liability should be recognised.

Other indicators that a lease is a finance lease include:

- At the inception of the lease the present value of the minimum lease payments\* amounts to substantially all of the fair value of the asset
- The lease agreement transfers ownership of the asset to the lessee by the end of the lease
- The leased asset is of a specialised nature
- The lessee has the option to purchase the asset at a price expected to be substantially lower than the fair value at the date the option becomes exercisable

### **Finance lease accounting**

#### ***Initial accounting***

The initial accounting is that the lessee should capitalise the finance leased asset and set up a lease liability for the value of the asset recognised. The accounting for this will be:

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Dr Non-current assets

Cr Finance lease liability

(This should be done by using the lower of the fair value of the asset or the present value of the minimum lease payments\*.)

*\*Note The present value of the minimum lease payments is essentially the lease payments over the life of the lease discounted to present value – you will either be given this figure in the Paper F7 exam or, if not, use the fair value of the asset. You will not be expected to calculate the minimum lease payments..*

### **Subsequent accounting**

#### **Depreciation**

Following the initial capitalisation of the leased asset, depreciation should be charged on the asset over the shorter of the lease term or the useful economic life of the asset. The accounting for this will be:

Dr Depreciation expense

Cr Accumulated depreciation

#### **Lease rental/interest**

When you look at a lease agreement it should be relatively easy to see that there is a finance cost tied up within the transaction. For example, a company could buy an asset with a useful economic life of four years for \$10,000 or lease it for four years paying a rental of \$3,000 per annum.

If the leasing option is chosen, over a four-year period the company will have paid \$12,000 in total for use of the asset (\$3,000 pa x 4 years), ie the finance charge in this example totals \$2,000 (the difference between the total lease cost (\$12,000) and the purchase price of the asset (\$10,000)).

When a company pays a rental, in effect it is making a capital repayment (ie against the lease obligation) and an interest payment. The impact of this will need to be shown within the financial statements in the form of a finance cost in the income statement and a reduction of the outstanding liability in the statement of financial position. In reality there are several ways that this can be done, but the Paper F7 examiner has stated that he will examine the actuarial method only.

The actuarial method of accounting for a finance lease allocates the interest to the period it actually relates to, ie the finance cost is higher when the capital outstanding is greatest, but as the capital gets repaid, interest payments become lower (similar to a repayment mortgage that you may have on your property). To allocate the interest to a specific period you will require the interest rate implicit within the lease

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agreement – again this will be *provided in the exam* and you are not required to calculate it.

One of the easiest ways to apply the actuarial method in the exam is to use a leasing table. Please take note of when the rental payment is actually due, is it in advance (ie rental made at beginning of the lease year) or is it in arrears (ie rental made at the end of the lease year)? This will affect the completion of the lease table as highlighted below:

### Rental payments in advance

Year	B/fwd	Rental	Capital o/s	Interest (rate given)	C/fwd
X	X	(X)	X	X	X
				<b>To income statement (finance costs)</b>	<b>To statement of financial position (liability)</b>

### Rental payments in arrears

Year	B/fwd	Interest (rate given)	Rental	C/fwd
X	X	X	(X)	X
		<b>To income statement (finance costs)</b>	<b>To statement of financial position (liability)</b>	

Tip: to be technically accurate the lease liability should be split between a non-current liability and a current liability.

### Example 1 – Rentals in arrears treatment

On 1 April 2009 Bush Co entered into an agreement to lease a machine that had an estimated life of four years. The lease period is also four years, at which point the asset will be returned to the leasing company. Annual rentals of \$5,000 are payable in arrears from 31 March 2010. The machine is expected to have a nil residual value at the end of its life. The machine had a fair value of \$14,275 at the inception of the lease. The lessor includes a finance cost of 15% per annum when calculating annual rentals.

How should the lease be accounted for in the financial statements of Bush for the year end 31 March 2010?

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### Solution

The lease should be classified as a finance lease as the estimated life of the asset is four years and Bush retains the right to use this asset for four years in accordance with the lease agreement therefore enjoying the rewards of the asset.

**Initial accounting:** recognise the asset and the lease liability

Dr Property, plant and equipment	14,275
Cr Finance lease obligations	14,275

**Subsequent accounting:** depreciation

Dr Depreciation expense (\$14,275 / 4 years)	3,568
Cr Accumulated depreciation	3,568

**Subsequent accounting:** lease rental/interest

Tip: use the lease table and complete next year as well to help you complete the split between non-current and current liabilities.

Year	B/fwd	Interest (15%)	Rental	C/fwd
1	14,275	2,141	(5,000)	11,416
2	11,416	1,712	(5,000)	8,128

### Income statement extract

Depreciation	3,568
Finance costs	2,141

↑ NCL

### Statement of financial position extract

#### Non-current assets

Carrying value machine <b>(14,275 – 3,568)</b>	10,707
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#### Non-current liabilities

Lease obligation	8,128
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#### Current liabilities

Lease obligation

Capital <b>((11,416 – 8,128)</b>	3,288
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### Example 2 – Rentals in advance treatment

On 1 April 2009 Shrub Co entered into an agreement to lease a machine that had an estimated life of four years. The lease period is also four years at which point the asset will be returned to the leasing company. Shrub is required to pay for all maintenance and insurance costs

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relating to the asset. Annual rentals of \$8,000 are payable in advance from 1 April 2009. The machine is expected to have a nil residual value at the end of its life. The machine had a fair value of \$28,000 at the inception of the lease. The lessor includes a finance cost of 10% per annum when calculating annual rentals.

How should the lease be accounted for in the financial statements of Shrub for the year end 31 March 2010?

### Solution

The lease should be classified as a finance lease as the estimated life of the asset is four years and Shrub retains the right to use this asset for four years in accordance with the lease agreement therefore enjoying the rewards of the asset. In addition to this Shrub is required to maintain and insure the asset, therefore retaining the risks of asset ownership.

**Initial accounting:** recognise the asset and the lease liability

Dr Property, plant and equipment	28,000
Cr Finance lease obligations	28,000

**Subsequent accounting:** depreciation

Dr Depreciation expense	7,000
(\$28,000 / 4 years)	
Cr Accumulated depreciation	7,000

**Subsequent accounting:** lease rental/interest

Year	B/fwd	Rental	Capital o/s	Interest <b>(10%)</b>	C/fwd
1	28,000	(8,000)	20,000	2,000	22,000
2	22,000	(8,000)	14,000		

**Income statement extract**

Depreciation	7,000
Finance costs	2,000

↖ NCL

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### *Statement of financial position extract*

#### *Non-current assets*

Carrying value machine	21,000
<b>(28,000 – 7,000)</b>	

#### *Non-current liabilities*

Lease obligation	14,000
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#### *Current liabilities*

Lease obligation	
Accrued interest	2,000
Capital <b>((22,000 – 14,000) – 2,000)</b>	<b>6,000</b>

### **Example 3 – Split lease year treatment**

On 1 October 2008 Number Co entered into an agreement to lease a machine that had an estimated life of four years. The lease period is also four years with annual rentals of \$10,000 payable in advance from 1 October 2008. The machine is expected to have a nil residual value at the end of its life. The machine had a fair value of \$35,000 at the inception of the lease. The lessor includes a finance cost of 10% per annum when calculating annual rentals.

How should the lease be accounted for in the financial statements of Number for the year end 31 March 2010?

### **Solution**

The lease should be classified as a finance lease as the estimated life of the asset is four years and Number retains the right to use this asset for four years in accordance with the lease agreement therefore enjoying the rewards of the asset.

**Initial accounting:** recognise the asset and the lease liability

Dr Property, plant and equipment	35,000
Cr Finance lease obligations	35,000

**Subsequent accounting:** depreciation

Tip: the depreciation for the year ended 31 March 2010 is a straightforward annual charge, but you will also have to take into account the depreciation for the first six months of the lease that was attributable to the year ended 31 March 2009 as this will be required to find the closing carrying value in the statement of financial position.

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**1 October 2008 – 31 March 2009**

Dr Depreciation expense 4,375

(\$35,000 / 4 years x 6/12)

Cr Accumulated depreciation 4,375

**1 April 2009 – 31 March 2010**

Dr Depreciation expense 8,750

(\$35,000 / 4 years)

Cr Accumulated depreciation 8,750

**Subsequent accounting:** lease rental/interest

Tip: you are looking for the outstanding value of the lease 18 months after the lease agreement began. It is advisable that you extend your lease table so that you have two separate 'c/fwd' balances – the balance at the end of the accounting year (31 March) and the balance at the end of the lease year (30 September).

Year	B/fwd	Rental	Capital o/s	Interest (10%) (6 months)	C/fwd (31 Mar)	Interest (10%) (6 months)	C/fwd (30 Sep)
1	35,000	(10,000)	25,000	1,250	26,250	1,250	27,500
2	27,500	(10,000)	17,500	875	<b>18,375</b>	875	19,250
3	19,250	(10,000)	<b>9,250</b>				

↙ NCL

**Income statement extract 31 March 2010**

Depreciation 8,750

Finance costs 2,125

**(1,250 + 875)****Statement of financial position extract 31 March 2010***Non-current assets*

Carrying value machine 21,875

**(35,000 – 4,375 (first 6 months depreciation) – 8,750 (current year charge))***Non-current liabilities*

Lease obligation 9,250

*Current liabilities*

Lease obligation

Interest 875

Capital **((18375 - 9,250) - 875)** 8,250



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### Operating lease accounting

As the risks and rewards of ownership of an asset are not transferred in the case of an operating lease, an asset is not recognised in the statement of financial position. Instead rentals under operating leases are charged to the income statement on a straight-line basis over the term of the lease, any difference between amounts charged and amounts paid will be prepayments or accruals.

### Example 4 – Operating lease treatment

On 1 October 2009 Alpine Ltd entered into an agreement to lease a machine that had an estimated life of 10 years. The lease period is for four years with annual rentals of \$5,000 payable in advance from 1 October 2009. The machine is expected to have a nil residual value at the end of its life. The machine had a fair value of \$50,000 at the inception of the lease.

How should the lease be accounted for in the financial statements of Alpine for the year end 31 March 2010?

### Solution

In the absence of any further information, this transaction would be classified as an operating lease as Alpine does not get to use the asset for most of/all of the assets useful economic life and therefore it can be argued that they do not enjoy all the rewards from this asset.

In addition to this, the present value of the minimum lease payments, if calculated (you are not required to do this in the exam, only use if the examiner gives to you) would be substantially less than the fair value of the asset.

The accounting for this lease should therefore be relatively straightforward and is shown below:

Rental of \$5,000 paid on 1 October:	
Dr Lease expense (income statement)	5,000
Cr Bank	5,000

This rental however spans the lease period 1 October 2009 to 30 September 2010 and therefore \$2,500 (the last six-months' rental) has been prepaid at the year end 31 March 2010.

Dr Prepayments	2,500
Cr Lease expense	2,500

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### *Income statement extract*

Lease expense	2,500
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### *Statement of financial position extract*

Current assets:

Prepayments	2,500
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### **Example 5 – Initial rent free incentive**

A Co entered into an agreement to lease office space on 1 April 2009 for a fixed period of five years. As an incentive to encourage the office space to be occupied, a first year rent-free period was included in the agreement after which A Co is required to pay an annual rental of \$36,000.

How should the lease be accounted for in the year ended 31 March 2010?

### **Solution**

The total cost of leasing the office space is \$144,000 ( $\$36,000 \times 4$  years). Despite there being a 'rent-free' period the total cost of the lease should be matched to the period in which it relates.

Therefore, in year 1:

### *Income statement extract*

Rental	\$28,800
(\$144,000 / 5 years)	

### *Statement of financial position extract*

Current liabilities

Accruals	\$28,800
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In summary, the accounting topic of leases is a really important accounting area and is highly examinable. To master this topic, ensure that you know the definitions of both types of lease, the recognition criteria for a finance lease and practise plenty of examples of accounting for finance leases.

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