

# A86045 Accounting and Financial Reporting (2017/2018)

Session 10

Leases

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# **SESSION 10 OVERVIEW AND OBJECTIVES**

# Course Overview

PGS	1. Financial reporting under IFRS	14. Construction contracts	PGS
	2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
	3. Financial analysis: Segments and EPS	16. Review session	
	4. Review session	17. Mid term test	
PGS	5. Revenues	18. Financial Instruments 1	PT
	6. Costs and expenses	19. Financial Instruments 2	
	7. Taxation - Direct and Indirect	20. Review session	
	8. Non-current assets - Intangible assets	21. Cash Flow Statement	
PT	9. Non-current assets - Tangible assets	22. Group accounts/Business comb	PGS
	10. Financial leases	23. Review session	
	11. Impairment of assets	24. Review session	
	12. Review session	25. Final test	
PT	13. Inventories		

# Objectives of Session 15

*At the end of this session session students will understand:*

- *The definition of a lease*
- *how to distinguish between an **operating lease** and a **finance lease** and*
- *the accounting treatment of these*
  - *By lessees*
  - *By lessors*
- *Required disclosures*
- *The changes that will take place with the introduction of **IFRS 16 effective 1 January 2019***

# Overview of Session 10

- Leasing (IAS 17)
  - Finance or operating
  - Lessee vs. lessor accounting
  - Sale and leaseback transactions
  - Disclosures
- Leasing (IFRS 16)
  - The need for change
  - Changes in Lessee vs. lessor accounting
  - Impact on Performance metrics
  - Effective date and transition

# Session 10 Overview

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# **SESSION 9 RECAP AND PRE-WORK FOR SESSION 10**

# Recap of Session 9

- Tangible Fixed Assets
  - Acquired vs constructed
  - Capital vs. revenue expenditures
  - Interest
  - Government Grants
  - Depreciation
  - Revaluations
  - De-recognition
  - Leasing – briefly
- Investment properties



# Session 10 Pre-work

- Reading
  - Melville International Financial Reporting
    - Chapter 5 – Property, plant and equipment
  - IASB Statements
    - IAS 16 Property, plant and equipment
    - IAS 40 Investment Property
- Exercises
  - Melville On-line multiple choice questions for Chapter 5
  - Melville Exercises 5.1 – 5.8
  - EX 9 Property, plant and equipment - Exercises
- Research assignment
  - RA 8 Identify how leases are accounted for in your chosen company.

# Research Assignment 8 - Leases

Company\_\_\_\_\_

	As Lessor	As Lessee
Finance leases		
Operating Leases		
Accounting policies		
Disclosures		
Impact of IFRS 16		

# LEASES – IAS 17

# Leases – IAS 17

**Definition:** A lease is an agreement whereby the *lessor* conveys to the *lessee* in return for a payment or series of payments the right to use an asset for an agreed period of time.

## **Finance Lease**

A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

## **Operating Lease**

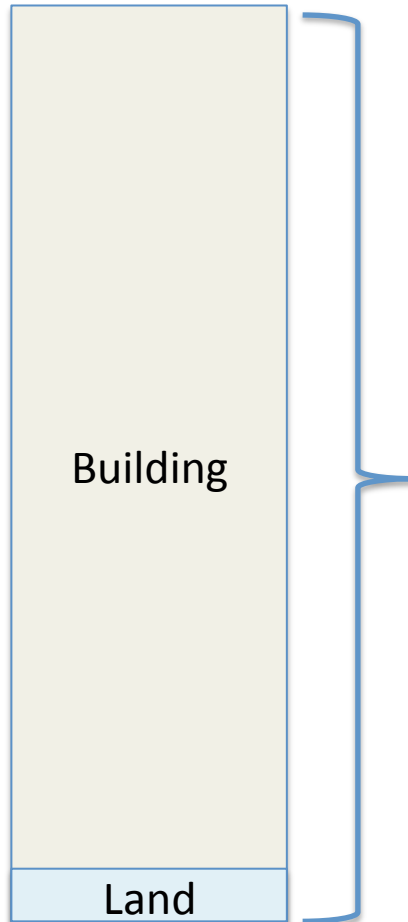
A lease other than a finance lease.

# Finance Lease

Classification is based on the **substance** and **not** the **form** of the contract. Situations that individually or in combination would normally lead to a lease being classified as a finance lease:

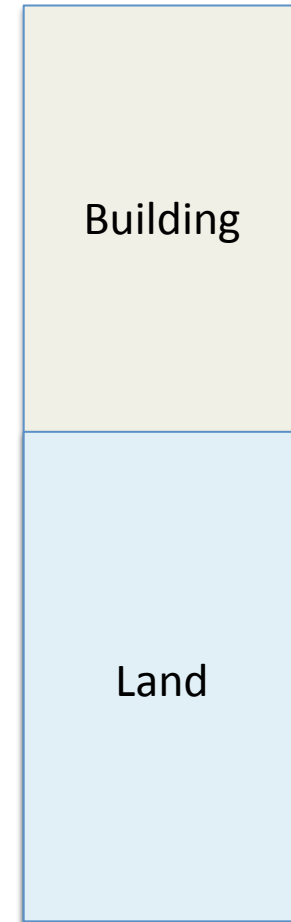
- The lease transfers **ownership** of the asset to the lessee at the end of the lease term; **(but not a requisite)**
- The lessee has the **option to purchase** the assets at a price that is expected to be significantly lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- The lease term is for the **major part of the economic life** of the asset even if title is not transferred; **(US GAAP >75%)**
- 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 **(not defined say >90%)**
- The leased assets are of such a **specialized nature** that only the lessee can use them without major modifications.

# Land and Buildings



If land is immaterial treat as a single unit

*When a lease includes both land and buildings, an entity assesses the classification of each element as a finance or operating lease separately. In determining whether the land element is an operating or finance lease, an important consideration is that land normally has an indefinite life*



# Lease Accounting – Finance Leases

## Lessor

- Lessors 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 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.

## Lessee

- At the commencement of the lease term, lessees shall recognize finance leases as **assets and liabilities** in their statements 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, each determined at the inception of the lease**. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lease are added to the amount regarded as an asset.
- **Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability**. The finance charge shall be allocated to each period during the lease term so as to produce **a constant periodic rate of interest** on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.
- **A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense** for each accounting period. The depreciation policy for depreciable assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognized shall be calculated in accordance with IAS 16 and IAS 38. **If there is no reasonable certainty that the lease will transfer 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.**

# Lease Accounting - Operating Leases

## Lessor

- Lessors shall present **assets** subject to operating leases in their statements of financial position according to the nature of the asset.
- Lease income from operating leases shall be recognized in income on **a straight-line basis over the lease term** unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.
- **Initial direct costs** incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis as the lease income.
- The **depreciation policy** for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and shall be calculated in accordance with IAS 16 and IAS 38.

## Lessee

- Lease payments under an operating lease shall be recognized on a **straight-line basis over the lease term** unless another systematic basis is more representative of the time pattern of the user's benefit.
- N.B. **Lease incentives** such as up-front payments or rent-free periods should be recognized as a reduction in the rental over the life of the lease



# **RESEARCH ASSIGNMENT RA 8 LEASES**

# Research Assignment 8 - Leases

Company\_\_\_\_\_

	As Lessor	As Lessee
Finance leases		
Operating Leases		
Accounting policies		
Disclosures		
Impact of IFRS 16		

Finance Lease

# LESSEE ACCOUNTING

# Lessee accounting -example

**Details of a non-cancellable lease are as follows:**

Fair value of asset = €10,000

Five annual rentals payable in advance of €2,100

Lessor's unguaranteed estimated residual value at the end of five years = €1,000

**Step 1 Calculate (a) the implicit interest rate and (b) the present value of minimum lease payments.**

## Calculation of the implicit interest rate in the cash flows

1	7.900	(10,000 - 2,100)
2	-2.100	
3	-2.100	
4	-2.100	
5	-2.100	
	-1.000	

IRR 6,62% Excel calculation

## Proof of implicit interest rate

Year	Capital at Start	Payments	Capital During	Interest On Capital 6,62%	Capital at End
1	10.000	- 2.100	7.900	523	8.423
2	8.423	- 2.100	6.323	419	6.742
3	6.742	- 2.100	4.642	307	4.949
4	4.949	- 2.100	2.849	189	3.038
5	3.038	- 2.100	938	62	1.000
		- 10.500		1.500	

Present value of lease payments

PV

9.274

Calculated using formulas in Excel and the cash flows

% of FV

93%

The PV of minimum lease payments is substantially all of the fair value therefore this is a finance lease

# Lessee accounting –example cont'd

## Allocation of finance costs

Year	Liability at Start	Rental Paid	Liability During	Interest On Liability 6,62%	Liability at End	Current Liability	Non Current Liability
1	9.274	2.100	7.174	475	7.649	1.733	5.917
2	7.649	2.100	5.549	367	5.917	1.847	4.069
3	5.917	2.100	3.817	253	4.069	1.970	2.100
4	4.069	2.100	1.969	130	2.100	2.100	-0
5	2.100	2.100	-0	-0	-0		
		10.500		1.226			

## Accounting for the leased asset

Year	Carrying value	Depreciation Charge	Accumulated Depreciation	Carrying Value End
1	9.274	1.855	1.855	7.419
2	9.274	1.855	3.710	5.564
3	9.274	1.855	5.564	3.710
4	9.274	1.855	7.419	1.855
5	9.274	1.855	9.274	-

# Lessee accounting –example cont'd

## Balance sheet and income statement amounts

Year	Carrying value Asset	Liability at End Period	Interest Expense	Depreciation Expense	Total Expense	Lease Payments
1	7.419	7.649	475	1.855	2.330	2.100
2	5.564	5.917	367	1.855	2.222	2.100
3	3.710	4.069	253	1.855	2.108	2.100
4	1.855	2.100	130	1.855	1.985	2.100
5	-	-	-0	1.855	1.855	2.100
			1.226	9.274	10.500	10.500

Finance Lease

# LESSOR ACCOUNTING

# Lessor accounting - example

The lease has the same facts as the lessee example. The lessor's gross investment in the lease is the total rents receivable of €10,500 and the unguaranteed residual value of €1,000. The gross earnings are therefore €1,500. The initial carrying value of the receivable is its fair value of €10,000, which is also the present value of the gross investment discounted at the interest rate implicit in the lease of 6,62%.

Year	Receivable at start of period a)	Rental received b)	Finance income 6,62% (on a-b)	Gross investment end of period*	Gross earnings allocated to future periods**	Receivable at end of period
1	10.000	2.100	523	9.400	977	8.423
2	8.423	2.100	419	7.300	558	6.742
3	6.742	2.100	307	5.200	251	4.949
4	4.949	2.100	189	3.100	62	3.038
5	3.038	2.100	62	1.000	0	1.000
		10,500	1,500			

<b>Gross earnings</b>	
Rentals	10.500
Fair value	<u>10.000</u>
	500
Residual	<u>1.000</u>
	1.500

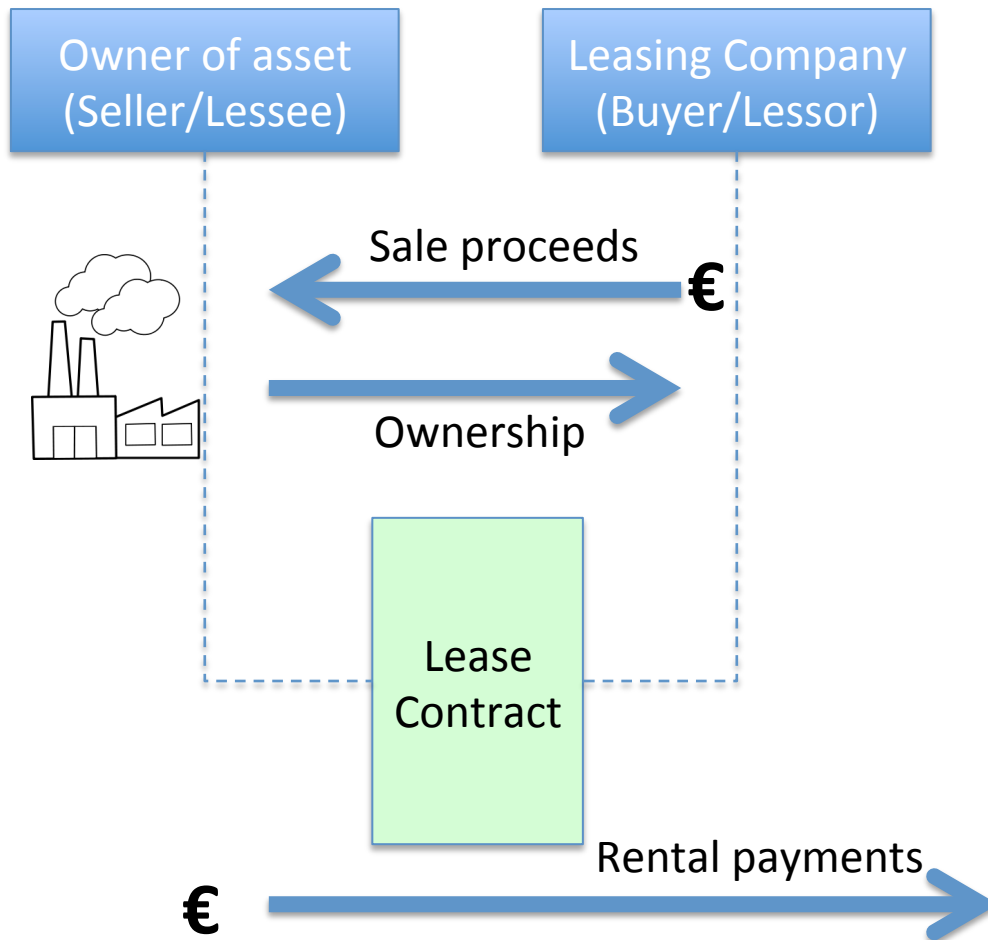
\*The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value.

\*\* Gross earnings less finance income recognized to date

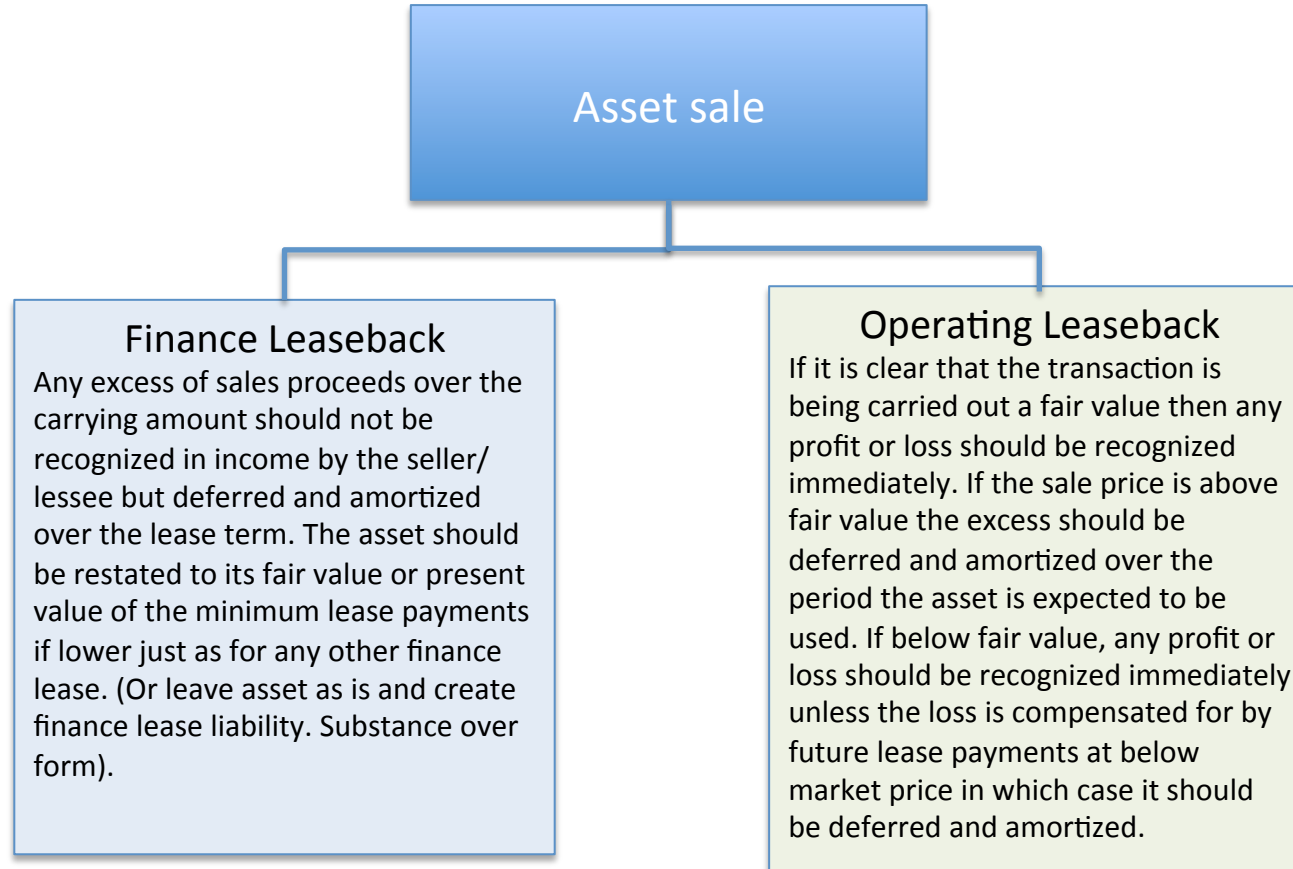


# SALE AND LEASEBACK

# Sale and Leaseback



# Sale and Lease back



# DISCLOSURES IAS 17

# Disclosures – Operating Leases

## The lessee

- the amount of operating lease payments recognised as an expense during the accounting period
- analysis of the total of the future minimum lease payments payable under non-cancellable operating leases.

## The lessor

- analysis of the total of the future minimum lease payments receivable under non-cancellable operating leases.

# Disclosures – Finance Leases

## The lessee

- for each class of asset, the net carrying amount of assets held under finance leases
- analysis of the total of the future minimum lease payments payable under finance leases.

## The lessor

- analysis of the total of the future minimum lease payments receivable under finance leases
- total amount of unearned finance income outstanding at the end of the reporting period.

# LEASES IFRS 16

# IFRS 16

- The need for change
- What's changing for lessors and lessees
- Lessee's performance metrics
- Effective date and transition



# The need for change

Leases are an important and flexible source of financing-listed companies using IFRS Standards or US GAAP are estimated to have around **US\$ 3.3 trillion** in lease commitments.

**Over 85% of these lease commitments do not appear on the balance sheet today**

Therefore, it is difficult for investors and others to:

- Get an **accurate** picture of a company's lease assets and liabilities
- **Compare** companies that lease assets with those who buy assets
- Estimate the amount of off-balance sheet obligations: often **overestimated**

# What's changing for lessors and lessees?

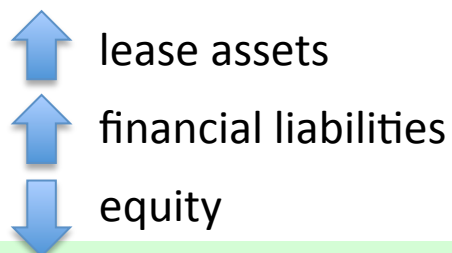
## Changes to lessor accounting

IAS 17 requirement substantially carried forward

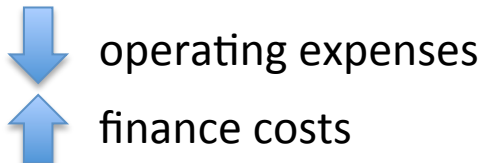
## Changes to lessee accounting

Leases presently accounted for as operating leases will be accounted for as today's finance leases\*

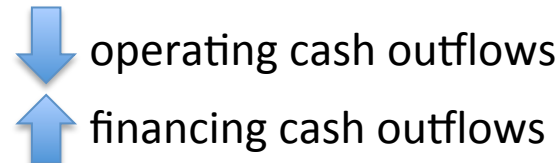
### Balance sheet



### Income statement



### Cash flow statement



The effects are on reported information but will not impact a lessee's economic position or commitments to pay cash

\* Exemptions for short-term leases and leases of low value items

# Lessee's performance metrics

These new requirements will affect key ratios that are used to analyse a company's financial leverage and performance:

Metric	Measure	Calculation	Effect
Leverage	Solvency	Borrowings/Equity	Increase
Assets Turnover	Profitability	Sales/Long-term assets	Decrease
EBIT/Operating profit	Profitability	Various	Increase
EBITDA	Profitability	EBITDA	Increase
EBITDAR	Profitability	EBITDAR	No change

# Lease accounting IFRS 16 - Lessees

At the commencement of a lease, the lessee should normally recognise **a right-of-use asset** and a corresponding **lease liability**.

A right-of-use asset is "*an asset that represents a lessee's right to use an underlying asset for the lease term*".

The requirement to recognise a right-of-use asset and a lease liability is not mandatory for short-term leases (12 months or less) or for leases of low-value assets.

# Effective date and transition

- IFRS 16 effective beginning 1 January 2109
- Early application permitted
- Cumulative catch-up method option
  - No restatement of comparatives
  - No need to apply to leases ending within 12 months
  - Simplified measurement option on transition

# **OVERVIEW, REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION**

# Session 11 Pre-work

- Reading
  - Melville International Financial Reporting
    - Chapter 9 – Leases
  - IASB Statements
    - IAS 17 Leases
    - IFRS 16 Leases
- Exercises
  - Melville On-line multiple choice questions for Chapter 9
  - Melville Exercises 9.1 – 9.8
  - EX 10 Leases- Exercises
- Research assignment
  - RA 9 Identify how your chosen company performs reviews for the impairment of its assets .

# Overview of Session 11

- Impairment of assets
  - Definition and rules
  - Identification of potential impairments
  - Measuring the recoverable amount
    - Fair value less cost of disposal (FVLCD)
    - Value in use (VIU)
  - Recognition and measurement
  - Cash-generating units and goodwill
  - Reversal of impairment losses
  - Some group issues



# Research assignment RA 9

## Impairment Testing

Company\_\_\_\_\_

Accounting policies/principles

Impairment tests: Goodwill and other intangibles

Impairment tests: Property, plant and equipment

# SUMMARY AND VALIDATION

# Summary of Session 10

- Leasing (IAS 17)
  - Finance or operating
  - Lessee vs. lessor accounting
  - Sale and leaseback transactions
  - Disclosures
- Leasing (IFRS 16)
  - The need for change
  - Changes in Lessee vs. lessor accounting
  - Impact on Performance metrics
  - Effective date and transition

# Session 10 Validation

- What are the criteria for determining if a lease is a finance lease or an operating lease?
- How does a lessee account for a finance lease?
- How does a lessor account for an operating lease?
- What is a sale and leaseback arrangement and how is this accounted for?
- What changes in lease accounting will take place with the introduction of IFRS 16?

# Accounting for operating lease terminations

Transaction	Lessor	Old tenant	New tenant
<b>Lessor pays</b>			
Old tenant – lessor intends to renovate the building	Expense immediately, or Capitalize as part of the carrying amount of the leased asset if meets IAS 16 criteria of construction cost.	Recognize in income immediately	
Old tenant – new lease with higher quality tenant	Expense immediately	Recognize in income immediately	
New tenant – an incentive to occupy	Prepayment amortized over the lease term on a straight-line basis		Deferred lease incentive amortized over the lease term on a straight-line basis
Building alterations specific to the tenant with no further value to the lessor after completion of the lease period	Prepayment amortized over the lease term on a straight line basis		Leasehold improvements capitalized and depreciated. Deferred lease incentive amortized over the lease term on a straight-line basis
<b>Old tenant pays</b>			
Lessor, to vacate the leased premises early	Recognized as income immediately to the extent not already recognized	Recognized as expense immediately to the extent not already recognized.	
New tenant to take over the lease		Recognize as an expense immediately	Recognize as income immediately, unless compensation for above market rentals, in which case amortize over expected lease term
<b>New tenant pays</b>			
Lessor to secure the right to obtain the lease	Recognize as deferred revenue under IAS 17 and amortize over the lease term on a straight-line basis		Recognize as a prepayment under IAS 17 and amortize over the lease term on a straight-line basis
Old tenant to buy out lease agreement		Recognize as a gain immediately	Recognize as an intangible asset with a finite economic life