Week 5: Leases -AASB 117 (currently)

Understand the nature of leases

What is lease? An agreement conveying the right to use a piece of property for a period, in return for a series of payments. -Lessor (owner of the property) / -Lessee

Key terms: period / payments (timing and amount) / cancellation (whether can be cancelled by either party) / ownership at the end / residual value / maintenance and repair costs, and etc.

Distinguish between an operating and a finance lease

Understand the implications of lease accounting for assessment of operating performance and financial risks

Accounting for an operating lease by the lessee

Accounting for finance leases in the books of the lessee

Operating lease: (managers like) the lessor retains most of the risks and rewards associated with ownership

AASB 117 para 33 lease payments under an operating lease shall be recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time patter of the user's benefit

typical short-term rental agreement / it is cancelled by lessee at little or no cost / return the assets at the end /

Implications:

does not satisfy the definition of assets and liabilities /

no lease assets or liabilities are recognized /

all lease payments are **expenses** / **off-balance sheet** /

Rental method: dr lease rental expense

Cr cash at bank

Disclosure: total future minimum lease payments for all non-cancellable leases split into payments due before 1 year, after 1 year and before 5 years & later than 5 years;

Finance lease: risks and rewards of ownership are transferred substantially to lessee

As a means of financing the long-term use and purchase of the assets / borrow and buy strategy / a secured loan from the lessor's viewpoint /

Implications:

satisfy the definition of assets and liabilities /

leased assets and liabilities /

lease payments split into interest and principal /

depreciation or amortization / **on-balance sheet** /

Debt ratio ↑ performance (e.g. return on total assets) ↓

Initial recognition:

AASB 117 para 20 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 leased payments, each determined at the inception of the lease. Interest rate: interest rate implicit in the lease over incremental borrowing rate

(1) Lower of the fair value and the PV of minimum lease payments
PV of minimum lease payments:
annual payment * annuity factor + **guaranteed residual value * PV factor + bargain purchase option * PV factor**

(2) + initial direct costs are added to the amount of the asset (e.g. legal costs or government charge)

If direct costs are added, only to assets, not to liability, assets amount – costs = lease liability

Dr leased assets
Cr lease liability

Subsequent measurement:

Dr lease liability a=c-b
Dr interest expense b=lease liability * the interest rate
Cr cash at bank c =the amount payable

-the reduction of liability is viewed as the repayment of principal;
-the principal is reduced by 'a';
-if there is a guaranteed residual value, it will be paid at the end of the lease term;
It will be covered in the PV of lease liability and repaid at last;

Year	Rental payments	Interest expense	Principal repayments	Lease liability
0				3605
1	1000	3605*12%=433	1000-433=567	3605-433=3038
2	1000	3038*12%=365	1000-365=635	3038-635=2403
3	1000	2403*12%=288	1000-288=712	2403-712=1691
4	1000	1691*12%=203	1000-203=797	1691-797=894
5	1000 + guaranteed residual value if any	1000+ guaranteed residual value if any -894=106	894	0
total	5000	1395	3605	

Dr executory expenses
Cr cash at bank
(e.g. maintenance or insurance)

Depreciation/amortization:

Dr depreciation expense / amortization expense
Cr accumulated depreciation / amortization of leased asset

Period: over the number of accounting periods the entity is expected to benefit from the assets;
If ownership will be obtained for sure, depreciate over useful life;

If not for sure, depreciate over lease term;
Guaranteed residual value is not included when depreciating.
Leased assets / periods = annual depreciation expense

Guaranteed residual value: the amount that the lessor is guaranteed from sale of the asset at the end of the lease term. Sometimes, lessee should pay the full amount of guaranteed residual value; other times lessee should pay the amount that the guaranteed residual value exceeds the amount for sale at the end; **included in minimum lease payment; no impact on depreciation**
If the residual is guaranteed, the PV of minimum lease payment = fair value
If the residual is not guaranteed, the amount of the lease assets or liability = the lower of the PV of minimum lease payments and fair value at the start;

Bargain purchase option: the right of the lessee to purchase the leased asset at the end at a price well below the estimated fair value at that time. **included in minimum lease payments**

Disclosure:
AASB 117 para 31 (b) a reconciliation between the total of future minimum lease payments at the end of the reporting period, and their present value

Other leases:
sale-and-leaseback agreement: alternative to raising cash by borrowing using the asset as security;
leverage lease: the fund for purchase is all borrowed;

Risk: possibilities of losses – from idle (闲置) capacity and technological obsolescence and changing economic conditions
Reward: profitable operation over the asset's life and gain from appreciation in value

Apply the requirements of AASB117 to the classification of leases
Classification: substance of the transaction (economic substance over legal form)!
AASB 117: the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lesser.
AASB 117 para 8: a lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
Indicators of finance lease: (require the exercise of judgment under AASB 117)
(1) transfer of ownership at the end;
(2) option to purchase at a bargain price;
(3) the lease term is covering most of asset's life; (previously indicated at least 75%)

(4) PV of minimum lease payments=fair value of the assets at the start; at least substantially (previously indicated at least 90%)
(5) only lessee can use the asset;
Other indicators of finance lease:
(6) whether the lease is cancellable as well; if cancelled, the loss of cancellation is attributed to the lessee;
(7) lessee bears the gains and losses on the fluctuation of fair value of the residual;
(8) lessee are allowed to continue the lease for a second rent at a rent substantially lower than market rent;

Understand the difference between expense and capitalization methods of accounting for finance leases in the books of a lessee **(expense vs capitalization)**
Lease capitalization approach: the assets and liabilities should have been recognized in the accounts of the lessee for finance leases / Provide more relevant information / a true and fair view

Understand the new approach to lease accounting IFRS16: Leases
-there is no operating and finance leases;
-lease agreements over 12 months are recognized as ‘right to use’ and ‘obligation to pay rentals’; Based on PV of lease payments;

Inconsistency with the *Framework*
Risks and rewards of ownership is inconsistent with definition of assets;