

Leases

Finance Lease	Transfers most risks and rewards incidental to ownership of the asset	On Balance Sheet
Operating Lease	Does NOT transfer the risk and rewards incidental to ownership of the asset	Off Balance Sheet

Risks

- Losses from idle capacity
- Technological obsolescence
- Profit variations from changes in economic conditions
- Uninsured damages

Rewards

- Profits over assets economic life
- Gains from appreciation in value
- Gains from realisation of residual value

Indicators of a Finance Lease

Para	Indicators
8	substantially all the risks and rewards incidental to ownership pass to the lessee
10(a)	Ownership transfers at lease end → Residual value is fully guaranteed by lessee
10(b)	Bargain purchase option
10(c)	Lease term major part of the economic life
10(d)	Present value of minimum lease payments at least substantially all of the fair value of the leased asset
10(e)	Specialised nature
11(a)	Lessee bears substantial costs to cancel
11(b)	Gains or losses in FV accrue to lessee
11(c)	Lessee can extend term at rate substantially lower than market rate

Present Value of Minimum Lease Payments

Minimum lease payments

required payments over the lease term → regular fixed lease payments (annuity) and residual value guaranteed by the lessee

Example:

Interest rate implicit in the lease is 15%

PV of 30,000 at Time ₀	\$30,000
PV 4 year annuity $30,000 \times (2.855)$	85,650
PV of residual $4,728 \times (1.15)^{-5} (0.497)$	<u>2,350</u>
PVMLP	<u>\$118,000</u>
Fair value + Lessor initial direct costs (0)	\$118,000

Discount Rate

interest rate implicit on the lease (IRR)

→ if IRR is impractical to calculate, use incremental borrowing rate

- the applied rate must cause the PV of minimum lease payments and unguaranteed residual value to equal the sum of the FV of the asset and initial costs of the lessor

Lessee: Financial Lease

Initial measurement

- must recognise finance leases as assets and liabilities at the lower of:
 - the fair value of the leased property
 - the present value of minimum lease payments
- any initial direct costs are added to the amount recognised
 - eg. commissions, legal fees, document preparation and processing

Step 1: Record lease asset and lease liability

Date	Details	DR	CR
	Leased Asset	X	
	Lease Liability		X
	<i>(initial recognition of lease asset and lease liability)</i>		

Step 2: Record the initial lease payment

Date	Details	DR	CR
	Lease Liability	X	
	Cash at Bank		X
	<i>(Record initial lease payment)</i>		

Subsequent Measurement

Lease Liability

- minimum lease payments are apportioned between finance charge and reduction of outstanding liability
- allocated each period during lease term to produce a constant periodic rate of interest on the remaining balance of the liability

Leased Asset

- depreciated using same policies as the lessee's owned assets – ignore residual value
- period of depreciation: use useful life → if useful life is uncertain, use term of lease
- subject to impairment

Step 3: Record the lease payment allocated between principal and interest, as per the schedule

Date	Details	DR	CR
	Interest Expense	X	
	Lease Liability	Y	
	Cash at Bank		X + Y
	<i>(Record lease payment)</i>		

Step 4: Record depreciation on leased asset

Date	Details	DR	CR
	Depreciation Expense	X	
	Accumulated Depreciation		X
	<i>(depreciation of leased asset *value/life*)</i>		

Note: RV is disregarded in depreciation calculations