1. Objective of HKAS 17

The objective of Hong Kong Accounting Standard (HKAS) 17 *Leases* is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

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. *(HKAS 17 para. 4)*

2. Scope of HKAS 17

HKAS 17 shall be applied in accounting for all leases other than:[2]

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, HKAS 17 shall not be applied as the basis of measurement for:

(a) property held by lessees that is accounted for as investment property (see HKAS 40* Investment Property*);

(b) investment property provided by lessors under operating leases (see HKAS 40);

(c) biological assets held by lessees under finance leases (see HKAS 41* Agriculture*); or

(d) biological assets provided by lessors under operating leases (see HKAS 41). *(HKAS 17 para. 2)*

HKAS 17 applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.

HKAS 17 does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

3. Classification of Leases

3.1 Risks and rewards approach

The classification of leases adopted in HKAS 17 is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

[1] *This note is sourced from HKAS 17 Leases. While the note is aimed at covering all critical points of HKAS 17, a complete and comprehensive coverage should still be the original standard, HKAS 17.*

[2] *All the paragraphs in the HKAS have equal authority now. While certain paragraphs in HKAS are highlighted in bold and italic, the same format is adopted in this note for those paragraphs.*

3.2 Financial lease and operating lease

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. *(HKAS 17 para. 8)*

In consequence, the definitions of leases are as follows:

> ***A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.***
>
> ***An operating lease is a lease other than a finance lease.*** *(HKAS 17 para. 4)*

Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

> ***Guaranteed residual value is:***
>
> ***(a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and***
>
> ***(b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.*** *(HKAS 17 para. 4)*

3.2.1 Hire purchase contract

The definition of a lease includes contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

3.3 Substance over form in classifying a lease

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. (See also HKAS-Int 27 *Evaluating the Substance of Transactions in the Legal Form of a Lease*)

> **Extract of HKAS-Int 27 Evaluating the Substance of Transactions in the Legal Form of a Lease**
>
> A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole.
>
> This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence.
>
> The accounting shall reflect the substance of the arrangement. All aspects and implications of an arrangement shall be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.
>
> HKAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under HKAS 17 include:
>
> (a) an Entity retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement;
>
> (b) the primary reason for the arrangement is to achieve a particular tax result, and not to convey the right to use an asset; and
>
> (c) an option is included on terms that make its exercise almost certain (e.g., a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).

3.4 Indicators of a finance lease

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently 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;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) 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

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

For point (a) above and in HKAS 17, the lease term is defined as follows:

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain. *(HKAS 17 para. 4)*

For point (c) above and in HKAS 17, the economic life is defined as follows:

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users. *(HKAS 17 para. 4)*

For point (d) above and HKAS 17, minimum lease payments are defined as follows:

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

(b) for a lessor, any residual value guaranteed to the lessor by:

(i) the lessee;

(ii) a party related to the lessee; or

(iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than 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 minimum lease payments comprise the minimum payments payable over the lease term to the expected date of

exercise of this purchase option and the payment required to exercise it.

<u>Contingent rent</u> is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (eg percentage of future sales, amount of future use, future price indices, future market rates of interest). *(HKAS 17 para. 4)*

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The examples and indicators set out above are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease.

For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

3.5 Lease classification made at the inception of the lease

Lease classification is made at the inception of the lease.

The <u>inception of the lease</u> is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

(a) a lease is classified as either an operating or a finance lease; and

(b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The <u>commencement of the lease term</u> is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate). *(HKAS 17 para. 4)*

3.5.1 Lease with provision to adjust lease payments

A lease agreement or commitment may include a provision to adjust the lease payments for changes in the construction or acquisition cost of the leased property or for changes in some other measure of cost or value, such as general price levels, or in the lessor's costs of financing the lease, during the period between the inception of the lease and the commencement of the lease term. If so, the effect of any such changes shall be deemed to have taken place at the inception of the lease for the purposes of HKAS 17.

3.5.2 Change of provision of a lease

If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria set out above if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term.

However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

3.6 Classification of leases of land and of buildings

Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets.

3.6.1 Leasehold land without an expected pass of title

However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.

3.6.2 Consider elements of a lease of land and buildings separately

The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification.

If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analysed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements.

When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term, in accordance with the above paragraph. The buildings element is classified as a finance or operating lease in accordance with the normal criteria under HKAS 17.

3.6.3 Allocation of minimum lease payments between land and buildings elements

Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.

3.6.4 No reliable allocation of minimum lease payments between land and buildings elements

If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

3.6.5 Immaterial land element initially recognised

For a lease of land and buildings in which the amount that would initially be recognised for the land element is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with paragraphs 7-13. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

3.6.6 Separate measurement of land and buildings elements not required for investment properties

Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with HKAS 40 and the fair value model is adopted. Detailed calculations are required for this assessment only if the classification of one or both elements is otherwise uncertain.

In accordance with HKAS 40, it is possible for a lessee to classify a property interest held under an operating lease as an investment property. If it does, the property interest is

accounted for as if it were a finance lease and, in addition, the fair value model is used for the asset recognised. The lessee shall continue to account for the lease as a finance lease, even if a subsequent event changes the nature of the lessee's property interest so that it is no longer classified as investment property. This will be the case if, for example, the lessee:

(a) occupies the property, which is then transferred to owner-occupied property at a deemed cost equal to its fair value at the date of change in use; or

(b) grants a sublease that transfers substantially all of the risks and rewards incidental to ownership of the interest to an unrelated third party. Such a sublease is accounted for by the lessee as a finance lease to the third party, although it may be accounted for as an operating lease by the third party.

4. Leases in the Financial Statements of Lessees

4.1 Finance Leases

4.1.1 Initial Recognition

At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to

(a) the fair value of the leased property, or

(b) 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 lessee are added to the amount recognised as an asset. *(HKAS 17 para. 20)*

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments and

(b) the unguaranteed residual value to be equal to the sum of

(i) the fair value of the leased asset and

(ii) any initial direct costs of the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset. *(HKAS 17 para. 4)*

1) Substance over form in accounting for a finance lease

Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with legal form. Although the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating, at the inception of the lease, the fair value of the asset and the related finance charge.

If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an entity are understated, thereby distorting

financial ratios. Therefore, it is appropriate for a finance lease to be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments.

At the commencement of the lease term, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts except for any initial direct costs of the lessee that are added to the amount recognised as an asset.

2) No offsetting is allowed

It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets. If for the presentation of liabilities on the face of the balance sheet a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.

3) Initial direct costs

Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognised as an asset.

4.1.2 Subsequent Measurement

Minimum lease payments shall be apportioned between

(a) the finance charge and

(b) 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. *(HKAS 17 para. 25)*

In practice, in allocating the finance charge to periods during the lease term, a lessee may use some form of approximation to simplify the calculation.

1) Depreciation for asset held under finance lease

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 leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with HKAS 16 Property, Plant and Equipment and HKAS 38 Intangible Assets.

If there is no reasonable certainty that the lessee will obtain 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. *(HKAS 17 para. 27)*

> ***Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.*** *(HKAS 17 para. 4)*

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term and its useful life.

2) **Depreciation expense for the asset and the finance expense for the period**

The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense. Accordingly, the asset and the related liability are unlikely to be equal in amount after the commencement of the lease term.

3) **Impairment of assets held under finance lease**

To determine whether a leased asset has become impaired, an entity applies HKAS 36 *Impairment of Assets*.

4.1.3 Lessees' disclosure on finance leases

Lessees shall, in addition to meeting the requirements of HKAS 32* Financial Instruments: Disclosure and Presentation*, make the following disclosures for finance leases:

(a) for each class of asset, the net carrying amount at the balance sheet date.

(b) a reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(c) contingent rents recognised as an expense in the period.

(d) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date.

(e) a general description of the lessee's material leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing. *(HKAS 17 para. 31)*

In addition, the requirements for disclosure in accordance with HKAS 16, HKAS 36, HKAS 38, HKAS 40 and HKAS 41 apply to lessees for assets leased under finance leases.

4.2 Operating Leases

Lease payments under an operating lease shall be recognised as an expense 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. (See also HKAS-Int 15* Operating Leases – Incentives*) *(HKAS 17 para. 33)*

For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

4.2.1 Lessees' disclosure on operating leases

Lessees shall, in addition to meeting the requirements of HKAS 32, make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date.

(c) lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

(d) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing. *(HKAS 17 para. 35)*

Examination question

Question *Modified from HKICPA CPA QP Final Professional Exam. 2002 December Case Question 2 (a)*

CPL has estimated that a machine with a market value of $5 million will be required, and it is expected to have a resale value of $1 million. This represents a fair estimate of the market value of the machine at the end of the project's five-year life. This machine is popular in Taiwan and it has a normal useful life of six years.

Alternatively, CPL could lease the machine for five equal annual payments of $1,050,000 commencing immediately and payable at the beginning of each year. The machine has to be returned to the lessor at the end of the lease period.

REQUIRED:
As the financial consultant, advise CPL the proper accounting treatment for the lease. (16 marks)

Answers

The accounting treatment of leases has significant impact on the balance sheet. With only minimal disclosure, leasing used to be attractive to certain firms as an "off-balance sheet" method of financing. Then came the HKAS 17 with an explicit ruling that called for the capitalisation on the balance sheet of certain types of leases.

In essence, HKAS 17 says that if the lessee acquires substantially all of the risks and benefits associated with the leased asset, then the value of the asset, along with the corresponding lease obligation, must be shown on the balance sheet. Leases that conform in principle to this definition are called finance leases. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

Examples of situations, which would normally lead to a lease being classified as a finance lease, are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term. This transfer of ownership is not found in this case.

(b) the lessee has the option to purchase the asset at a price, which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable. This option to purchase is not found in this case.

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred. In this case, the lease term is 5 years, which is about 83% of the total economic useful life (6 years). It is difficult for CPL to argue that the lease term is not for the major part of the economic life of the asset.

(d) at the inception of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. Before we can determine the present value of the minimum lease payments, we have to determine the implicit interest rate, where:

$1,050,000 x PVAA (5 years, r) + $1,000,000 x DF (5 years, r) = $5,000,000

If r = 10%:

$1,050,000 x 4.1698 + $1,000,000 x 0.6209 = 4,378,290 + 620,900 = 4,999,190 which is approximately equal to the fair value, thus the implicit interest rate is 10%.

Since CPL has not guaranteed any residual value, the present value of minimum lease payments = $1,050,000 x 4.1698 = $4,378,290. When compared to the fair value, 4,378,290 / 5,000,000 = 87.57%. Although it is slightly less than 90%, it still seems difficult for CPL to argue that the present value of the minimum lease payments does not amount to substantially all of the fair value of the leased asset.

(e) the leased assets are of a specialised nature such that only the lessee can use them without major modifications being made. As the machine is popular, this shows that it may not be of a specialised nature.

Since the lease term is for the major part (83%) of the economic life of the asset and the present value of the minimum lease payments amounts to a substantial portion of the fair value (87.57%) of the leased asset, it is difficult for CPL to argue that they have not acquired substantially all of the risks and benefits associated with the machine.

Thus the value of the asset ($4,378,290) along with the corresponding lease obligation should be shown on the balance sheet.

Lease payments ($1,050,000) should be apportioned between the finance charge and the reduction of the outstanding obligation. For example, at the end of year 1, $332,829 should be allocated to the finance charge and the balance ($717,171) should be regarded as the reduction of the outstanding obligation.

Principal	Payment	Outstanding	10%	c/d
4,378,290	1,050,000	3,328,290	332,829	3,661,119
3,661,119	1,050,000	2,611,119	261,112	2,872,231
2,872,231	1,050,000	1,822,231	182,223	2,004,454
2,004,454	1,050,000	954,454	95,546	1,050,000
1,050,000	1,050,000	0		0

This finance lease will give rise to a depreciation expense for the asset as well as a finance expense for each accounting period.

The depreciation policy for leased assets should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in HKAS 16 Property, plant and equipment. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life, thus a depreciation expense of $4,378,290 / 5 years = $875,658 will be recognised over the 5 years.

5. Leases in the Financial Statements of Lessors

5.1 Finance Leases

5.1.1 Initial Recognition

Lessors shall

(a) recognise assets held under a finance lease in their balance sheets and

(b) present them as a receivable at an amount equal to the net investment in the lease. *(HKAS 17 para. 36)*

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Gross investment in the lease is the aggregate of:

(a) the minimum lease payments receivable by the lessor under a finance lease, and

(b) any unguaranteed residual value accruing to the lessor

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor. *(HKAS 17 para. 4)*

Unearned finance income is the difference between:

(a) the gross investment in the lease, and

(b) the net investment in the lease. *(HKAS 17 para. 4)*

1) Risks and reward of ownership transferred

Under a finance lease substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.

2) Initial direct costs

Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team. For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the lease term.

The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable; there is no need to add them separately.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease and are recognised as an expense when the selling profit is recognised, which for a finance lease is normally at the commencement of the lease term.

5.1.2 Subsequent Measurement

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. *(HKAS 17 para. 39)*

A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease. Lease payments relating to the period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately.

An asset under a finance lease that is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 shall be accounted for in accordance with that HKFRS.

5.1.3 Leases for manufacturer or dealer lessors

Manufacturer or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.

If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised. *(HKAS 17 para. 42)*

1) Profit or loss and finance income

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) finance income over the lease term.

The sales revenue recognised at the commencement of the lease term by a manufacturer or dealer lessor is

(a) the fair value of the asset, or

(b) if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest.

The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased property less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the entity's policy for outright sales.

2) Artificially low rates of interests quoted

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit is restricted to that which would apply if a market rate of interest were charged.

3) Cost incurred in negotiation and arrangement

Costs incurred by a manufacturer or dealer lessor in connection with negotiating and arranging a finance lease are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

5.1.4 Lessors' disclosure on finance leases

Lessors shall, in addition to meeting the requirements in HKAS 32, disclose the following for finance leases:

(a) a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(b) unearned finance income.

(c) the unguaranteed residual values accruing to the benefit of the lessor.

(d) the accumulated allowance for uncollectible minimum lease payments receivable.

(e) contingent rents recognised as income in the period.

(f) a general description of the lessor's material leasing arrangements. *(HKAS 17 para. 47)*

As an indicator of growth it is often useful also to disclose the gross investment less unearned income in new business added during the period, after deducting the relevant amounts for cancelled leases.

5.2 Operating Leases

Lessors shall present assets subject to operating leases in their balance sheets according to the nature of the asset. *(HKAS 17 para. 49)*

Lease income from operating leases shall be recognised 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. (See also HKAS-Int 15 **Operating Leases – Incentives*)*** *(HKAS 17 para. 50)*

Costs, including depreciation, incurred in earning the lease income are recognised as expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised on a straight-line basis over the lease term even if the receipts are not on such a basis, 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 recognised as an expense over the lease term on the same basis as the lease income. *(HKAS 17 para. 52)*

The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with HKAS 16 and HKAS 38. *(HKAS 17 para. 53)*

To determine whether a leased asset has become impaired, an entity applies HKAS 36.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

5.2.1 Lessors' disclosure on operating leases

Lessors shall, in addition to meeting the requirements of HKAS 32, disclose the following for operating leases:

(a) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(b) total contingent rents recognised as income in the period.

(c) a general description of the lessor's leasing arrangements. *(HKAS 17 para. 56)*

In addition, the disclosure requirements in HKAS 16, HKAS 36, HKAS 38, HKAS 40 and HKAS 41 apply to lessors for assets provided under operating leases.

Examination question

Question *Modified from ACCA Paper 3.6 Pilot Paper Question 2(b)*

Axe's financial year end is 31 December 2000. The company has also leased motor vehicles on 1 January 2000 for the first time. 50 vehicles were leased at an annual rental of $5,000 each, payable on 1 January in advance.

In addition an extra $0.2 per kilometre is payable if the usage exceeds 50,000 kilometres over the three year rental period. The excess usage charge reflects fair compensation for the additional wear and tear of the vehicle. Axe returns the vehicle to the lessor at the end of the lease. The lessee maintains and insures the vehicles.

Advise the financial director on the way in which the above transaction would be dealt with under current Hong Kong Accounting Standards. (A discount rate of 10% should be used for 3 years at 10% is $2.49.)

Answers

Under existing accounting standards, the lease would be treated as an operating lease with any rental being charged to the income statement on a straight line basis over the lease term irrespective of the due dates of payment.

Axe also has the right to purchase additional usage of the vehicles at $0.2 per kilometre. As this rate is fair compensation for additional wear and tear, the option has little value and would be ignored. Such rentals based on contingent usage would be recognised as incurred. *(What is the implication of HKAS 32?)*

Examination question

Question *Modified from ACCA Paper 3.6H 2002 December Question 4(a)(iii)*

Inventure has paid an initial payment of $200,000 as a deposit under an operating lease. The payment has been capitalised as a non-current tangible asset and is to be amortised over the five year life of the operating lease. The initial payment has substantially reduced the annual rental expense to $100,000 per annum.

Discuss the nature and acceptability of the above accounting practice, advising the directors on the correct accounting treatment or actions that they should take.

Answers

HKAS 17 Leases requires that operating lease rentals are charged to the income statement on a straight line basis over the lease term irrespective of when payments are due.

A large up-front payment by the lessee should be allocated to the period over which the benefit is gained. The prepayment of the operating lease rental should be regarded as a prepaid lease payments and not as a non-current tangible asset. It should not be included in depreciation at a figure of $40,000 ($200,000 ÷ 5) but should be included in rental expense at this figure.

Comparability will be affected if the classification of the premium results in high amortisation and low rental expense, especially if earnings before interest, tax, depreciation and amortisation is being used as a performance measure.

6. Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

6.1 Sale and leaseback in a finance lease

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term. *(HKAS 17 para. 59)*

If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. For this reason it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term.

6.2 Sale and leaseback in an operating lease

If a sale and leaseback transaction results in an operating lease, the sale price of the transaction will be compared with its fair value.

(a) If it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately.

(b) If the sale price is below fair value, any profit or loss shall be recognised immediately except that,

if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

(c) If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used. *(HKAS 17 para. 61)*

If the leaseback is an operating lease, and the lease payments and the sale price are at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

6.2.1 Fair value less than carrying amount of the asset

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately. *(HKAS 17 para. 63)*

For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with HKAS 36.

6.3 Disclosure on sale and leaseback

Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

Sale and leaseback transactions may trigger the separate disclosure criteria in HKAS 1 *Presentation of Financial Statements*.

Examination question

Question *Modified from ACCA Paper 3.6 Pilot Paper Question 2(b)*

Axe's financial year end is 31 December 2000. On 1 January 2000, Axe sold its computer software and hardware to Lake, a public limited company, for $310 million. The assets were leased back for four years under an operating lease whereby Lake agreed to maintain and upgrade the computer facilities. The fair value of the assets sold was $190 million and the carrying value based on depreciated historic cost was $90 million. The lease rental payments were $45 million per annum, payable on 1 January in advance, which represented a premium of fifty per cent of the normal cost of such a lease.

Advise the financial director on the way in which the above transaction would be dealt with under current Hong Kong Accounting Standards. (A discount rate of 10% should be used for 3 years at 10% is $2.49.)

Answers

The assets which have been sold and leased back (the computer software and hardware) should be treated as a sale and the operating lease treated under HKAS 17 Leases which would keep the lease off the balance sheet and only charge the rentals against profit.

If the transaction is at fair value then immediate recognition of the profit or loss on the sale of the asset should occur. However, where the transaction is above fair value, the profit based on fair value should be recognised immediately ($190 million - $90 million, i.e. $100 million). The balance of the sales value over the fair value should be deferred and amortised over period for which the asset is expected to be used (($310 million - $190 million) ÷ 4 years, i.e. $30 million per annum).

However, as the sales value is not the fair value, it is evident that the rental payments have been adjusted for the excess price paid for the assets and it appears that the substance of the transaction is the sale of an asset and a loan which equates to the deferred income element. Thus the premium of $15 million may be more a financing cost with the excess over the fair value being shown as a loan ($120 million) with part of the costs of the operating lease being treated as repayment of capital and interest.

Examination question

Question *Modified from ACCA Paper 3.6 Pilot Paper Question 2(b)*

Axe's financial year end is 31 December 2000. On 1 January 2000 Axe sold plant with a carrying value of $200 million. The fair value and selling price of the plant was $330 million. The plant was immediately leased back over 4 years which is the remaining useful life of the asset. Axe has guaranteed a residual value of $30 million and the plant is to be sold for scrap at the end of the lease. Axe will be liable for any shortfall in the residual value. The lease cannot be cancelled and requires equal rental payments of $87 million at the commencement of each financial year. The "normal" cost of such a lease without the residual value guarantee would have been $95 million per annum. Axe pays the costs of all maintenance and insurance of the plant.

Advise the financial director on the way in which the above transaction would be dealt with under current Hong Kong Accounting Standards. (A discount rate of 10% should be used for 3 years at 10% is $2.49.)

Answers

The sale and leaseback of the plant appears to create a finance lease as the present value of the minimum lease payments is substantially all (98%) of the fair value of the plant and Axe pays all the costs of maintenance and insurance of the plant. The lease runs for the useful life of the plant and Axe has guaranteed a residual amount of $30 million. Thus the minimum lease payments are:

	$ million
$87 million + $87 million x 2.49	303.6
$30 million residual value discounted at 10%	20.5
	324.1

HKAS 17 states that if a sale and leaseback transaction results in a finance lease, any excess of sale proceeds over the carrying amount should not immediately be recognised as income. Instead it should be deferred and amortised over the lease term. The earnings process is not complete and a sale has not occurred. The rental payments have been reduced because the company has been prepared to guarantee a residual value of $30 million which is probably in excess of its scrap value which will potentially be low.

7. Transitional Provisions

Subject to the following paragraph, retrospective application of HKAS 17 is encouraged but not required. If HKAS 17 is not applied retrospectively, the balance of any pre-existing finance lease is deemed to have been properly determined by the lessor and shall be accounted for thereafter in accordance with the provisions of HKAS 17. *(HKAS 17 para. 67)*

An entity that has previously applied SSAP 14 (revised 2000) shall apply the amendments made by HKAS 17 retrospectively for all leases or, if SSAP 14 (revised 2000) was not applied retrospectively, for all leases entered into since it first applied HKAS 17. *(HKAS 17 para. 68)*

8. Effective Date

An entity shall apply HKAS 17 for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies HKAS 17 for a period beginning before 1 January 2005 it shall disclose that fact and apply HKAS Interpretation (HKAS-Int) 13 **Operating Leases - Incentives** ***at the same time.*** *(HKAS 17 para. 69)*

If an entity decides to apply HKAS 17 for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

Examination question

Question *Modified from ACCA Paper 3.6 2004 December Question 4(ii)*

Pohler Speed has leased electronic sorting systems to other companies on 30 November 2004. The beneficial and legal ownership remains with Pohler Speed and the assets remain available to Pohler Speed for its operating activities. The leased assets have been treated as operating leases with the net present value of the income stream of $100 million (including the deposit) being recognised in the income statement.

Pohler Speed estimates that the fair value of the assets leased was $140 million at the inception of the leases. Deposits of $20 million were received by Pohler Speed on 30 November 2004. No depreciation is to be charged on the leased assets for the current year.

Draft a report explaining recommended accounting practice in each of the above areas and discussing whether the accounting practices used by the company are acceptable, the issues involved. (5 marks)

Answers

INT14 'Evaluating the substance of transactions involving the legal form of a lease' considers whether a leasing agreement meets the definition of a lease in HKSSAP14 'Leases' and how a company should account for any fee that it might receive.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards 'incident' to ownership. All other leases are classified as operating leases. In this case, the beneficial and legal ownership remains with Pohler Speed, and Pohler Speed can in fact make use of the electronic sorting systems if it so wishes. Also for a lease asset to be a finance lease the present value of the minimum lease payments should be at least substantially all of the fair value of the leased asset (para 8d). In this case, this amounts to 71.4% ($100 million ÷ $140 million) which does not constitute 'substantially all'.

Thus there does not seem to be any issue over the classification of the lease as an operating lease. The immediate recognition as income of the future benefit at net present value is a little more problematical. HKSSAP14 says that lease income from operating leases should be recognised on a straight line basis over the lease term unless another systematic basis is more representative. If a fee is received as an 'up front' cash payment then HKSSAP18 'Revenue' (para 19) and INT14 should be applied. (See 'consensus' para 8) If there is future involvement required to earn the fee, or there are retained risks or risk of the repayment of the fee, or any restrictions on the lessor's use of the asset, then immediate recognition is inappropriate. The present policy of recognising the total lease income as if it were immediate income, which it is not, would be difficult to justify.

Similarly, as regards the deposit received, revenue should only be recognised when there is performance of the contract. Thus as there has been no performance under the contract, no revenue should be accrued in the period.

Examination question

Question *Modified from ACCA Paper 3.6 2005 June Question 4*

Local GAAP does not require property leases to be separated into land and building components. Long-term property leases are accounted for as operating leases in the financial statements of Handrew under local GAAP. Under the terms of the contract, the title to the land does not pass to Handrew but the title to the building passes to the company.

The company has produced a schedule of future minimum operating lease rentals and allocated these rentals between land and buildings based on their relative fair value at the start of the lease period. The operating leases commenced on 1 June 2004 when the value of the land was $270 million and the building was $90 million. Annual operating lease rentals paid in arrears commencing on 31 May 2005 are land $30 million and buildings $10 million. These amounts are payable for the first five years of the lease term after which the payments diminish. The minimum lease term is 40 years.

The net present value of the future minimum operating lease payments as at 1 June 2004 was land $198 million and buildings $86 million. The interest rate used for discounting cash flows is 6%. Buildings are depreciated on a straight line basis over 20 years and at the end of this period, the building's economic life will be over. The lessee intends to redevelop the land at some stage in the future. Assume that the tax allowances on buildings are given to the lessee on the same basis as the depreciation charge based on the net present value at the start of the lease, and that operating lease payments are fully allowable for taxation.

Write a report to the directors of Handrew discussing the impact of the change to HKFRS on the reported profit and balance sheet of Handrew at 31 May 2005.

Answers

When classifying a lease of land and buildings, HKAS 17 'Leases' requires the substance of the transaction to be reviewed and the land and buildings elements to be considered separately. The lease of land will normally be classed as an operating lease unless the title passes to the lessee at the end of the lease. The title does not pass in the case of the company's leased land and the net present value of the lease commitments was only 73% of the fair value of the land at 1 June 2004 which is not substantially all of the fair value of the leased asset. (Appendix 1) Although the title does not pass in the case of the company's leased land, it does in the case of the buildings.

Additionally, in the case of the buildings the lease runs for their economic life which would indicate that it is a finance lease. The lessee intends to redevelop the land which again indicates that this lease has a value that can be separated from the finance lease of the building. The substance of the transactions would seem to indicate that the land is an operating lease and the building is a finance lease especially as at the inception of the lease the present value of the minimum lease payments is substantially (96%) all of the fair value of the building (Appendix 1). Thus the payments made to the lessor for the building are a significant part of the asset's fair value indicating that the lessee is effectively purchasing the building.

This will result in an increase in the value of the non-current assets by $86 million and a corresponding increase in non-current liabilities. The non-current liability will be reduced by the payment already made ($10 million) and increased by the interest charge for the year ($5.2 million). Also the reclassification of the amount due on 31 May 2006 will be a current liability ($5.1 million). Thus non-current liabilities will increase by ($86 + 5·2 – 10 – 5·1m) $76.1 million. The building will be depreciated over 20 years straight line ($4.3 million per annum). The income statement will be charged with the depreciation and interest charges but will be credited with the operating lease rentals of $10 million. There will also be a tax effect as the operating lease rental payments will now not be included as a taxable expense.