

IAS 17 Leases

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Objective of IAS 17

- The objective of IAS 17 (Revised 1997) is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

[Scope]

- IAS 17 applies to all leases other than lease agreements for minerals, oil, natural gas, and similar regenerative resources and licensing agreements for films, videos, plays, manuscripts, patents, copyrights, and similar items. [IAS 17.2]
- However, IAS 17 does not apply as the basis of measurement for the following leased assets:
 - Property held by lessees that is accounted for as investment property for which the lessee uses the fair value model set out in IAS 40.
 - Investment property provided by lessors under operating leases (see IAS 40).
 - Biological assets held by lessees under finance leases (see IAS 41).
 - Biological assets provided by lessors under operating leases (see IAS 41).

Classification of Leases 1

- 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. Classification is made at the inception of the lease. [IAS 17.4]
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form. Situations that would normally lead to a lease being classified as a **finance lease** include the following: [IAS 17.10]

Classification of Leases 2

finance lease

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain 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;
- 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
- the lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Classification of Leases 3

finance lease

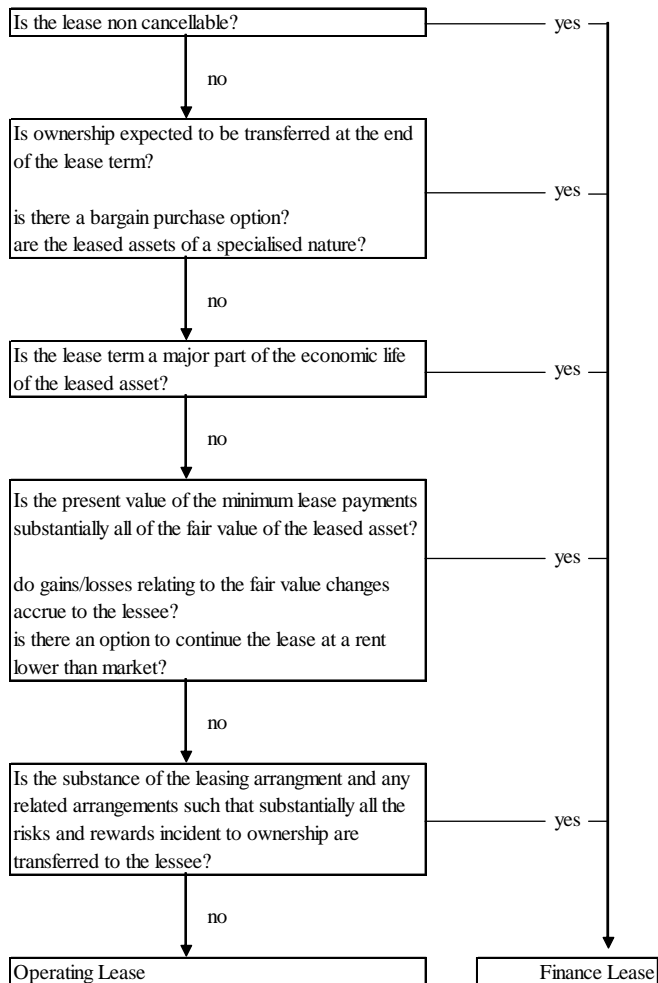
- Other situations that might also lead to classification as a finance lease are: [IAS 17.11]
- If the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, by means of a rebate of lease payments); and
- the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.

Classification of Leases 4

- In classifying a lease of land and buildings, land and buildings elements would normally be considered separately. The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values. The land element is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17. [IAS 17.15]
- However, separate measurement of the land and buildings elements is not required if the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. [IAS 17.18]

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Lease Classification Guidelines: IAS 17 paragraphs 10 and 11



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Accounting by Lessees 1

- The following principles should be applied in the financial statements of lessees:
- at commencement of the lease term, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease, if practicable, or else at the enterprise's incremental borrowing rate); [IAS 17.20]
- finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability (the finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability); [IAS 17.25]

Accounting by Lessees 2

- the depreciation policy for assets held under finance leases should be consistent with that for owned assets. If there is no reasonable certainty that the lessee will obtain ownership at the end of the lease: the asset should be depreciated over the shorter of the lease term and the life of the asset; [IAS 17.27] and
- for operating leases, the lease payments should be recognised as an expense in the income statement over the lease term on a straight line basis, unless another systematic basis is more representative of the time pattern of the user's benefit. [IAS 17.33]
- Incentives for the agreement of a new or renewed operating lease should be recognised by the lessee as a reduction of the rental expense over the lease term, irrespective of the incentive's nature or form, or the timing of payments. [[SIC 15](#)]

Accounting by Lessors 1

- The following principles should be applied in the financial statements of lessors:
- at commencement of the lease term, the lessor should record a finance lease in the balance sheet as a receivable, at an amount equal to the net investment in the lease; [IAS 17.36]
- the lessor should recognise finance income based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease; [IAS 17.39] and

Accounting by Lessors 2

- assets held for operating leases should be presented in the balance sheet of the lessor according to the nature of the asset. [IAS 17.49]
Lease income should be recognised over the lease term on a straight line basis, unless another systematic basis is more representative of the time pattern in which use benefit is derived from the leased asset is diminished. [IAS 17.50]
- Incentives for the agreement of a new or renewed operating lease should be recognised by the lessor as a reduction of the rental income over the lease term, irrespective of the incentive's nature or form, or the timing of payments. [[SIC 15](#)]

Accounting by Lessors 3

- Manufacturers or dealer lessors should include selling profit or loss in the same period as they would for an outright sale. If artificially low rates of interest are charged, selling profit should be restricted to that which would apply if a commercial rate of interest were charged. [IAS 17.42]
- Under the 2003 revisions to IAS 17, initial direct and incremental costs incurred by lessors in negotiating leases must be recognised over the lease term. They may no longer be charged to expense when incurred. This treatment does not apply to manufacturer or dealer lessors where such cost recognition is as an expense when the selling profit is recognised.

Sale and Leaseback Transactions

- For a sale and leaseback transaction that results in a finance lease, any excess of proceeds over the carrying amount is deferred and amortised over the lease term. [IAS 17.59]
- For a transaction that results in an operating lease: [IAS 17.61]
- if the transaction is clearly carried out at fair value: the profit or loss should be recognised immediately;
- if the sale price is below fair value: profit or loss should be recognised immediately, except if a loss is compensated for by future rentals at below market price, the loss it should be amortised over the period of use;
- if the sale price is above fair value: the excess over fair value should be deferred and amortised over the period of use; and
- if the fair value at the time of the transaction is less than the carrying amount: a loss equal to the difference should be recognised immediately. [IAS 17.63]

Disclosure: Lessees Finance Lease

- carrying amount of asset;
- reconciliation between total minimum lease payments and their present value;
- amounts of minimum lease payments at balance sheet date and the present value thereof, for:
 - the next year;
 - years 2 to 5 combined;
 - beyond five years;
- contingent rent recognised as an expense;
- total future minimum sublease income under non cancellable subleases; and
- general description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing.
[IAS 17.31]

Disclosure: Lessees

Operating Lease

- amounts of minimum lease payments at balance sheet date under non cancellable operating leases for:
 - the next year;
 - years 2 to 5 combined;
 - beyond five years;
- total future minimum sublease income under non cancellable subleases;
- lease and sublease payments recognised in income for the period;
- contingent rent recognised as an expense; and
- general description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing [IAS 17.35]

Disclosure: Lessors Finance Lease

- reconciliation between gross investment in the lease and the present value of minimum lease payments;
- gross investment and present value of minimum lease payments receivable for:
 - the next year;
 - years 2 to 5 combined;
 - beyond five years;
- unearned finance income;
- unguaranteed residual values;
- accumulated allowance for uncollectible lease payments receivable;
- contingent rent recognised in income; and
- general description of significant leasing arrangements
- [IAS 17.47]

Disclosure: Lessors Operating Lease

- amounts of minimum lease payments at balance sheet date under non cancellable operating leases in the aggregate and for:
 - the next year;
 - years 2 to 5 combined;
 - beyond five years;
- contingent rent recognised as in income; and
- general description of significant leasing arrangements
- [IAS 17.56]

Based on <http://www.iasplus.com/standard/ias17.htm>

[Reference]

- I recognise the help I received from the materials prepared by Deloitte, Touche, Tohmatsu in preparing this presentation.