IPSAS 13 Leases – as adopted by the Maltese Government

Guidelines

IPSAS Implementation Team

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Introduction

1. **IPSAS 13 Leases – as adopted by the Maltese Government**

   1.1 These guidelines refer to the Leases accounting standard **as adopted by the Maltese Government**. This version is very similar to the original IPSAS 13 developed by the International Public Sector Accounting Standards Board (IPSASB), with some changes more applicable in the local context. A summary of the significant differences with the original IPSAS 13 can be found as an Appendix to the standard, entitled Comparison with IPSAS 13.

2. **Scope**

   2.1 These guidelines were prepared to enable the users to:

      2.1.1 Develop a working-level knowledge of the principles contained in the accounting standard and

      2.1.2 Understand and appreciate the major challenges and benefits resulting from the implementation of IPSAS 13.[1]

3. **Target Audience**

   3.1 These guidelines are designed for finance and non-finance employees working in Central Government entities.

4. **Guidelines Structure**

   4.1 This document provides guidance on how an entity should classify a lease agreement and the accounting treatment and disclosure thereof. This guideline also includes examples providing further explanations on the concepts described in IPSAS 13.

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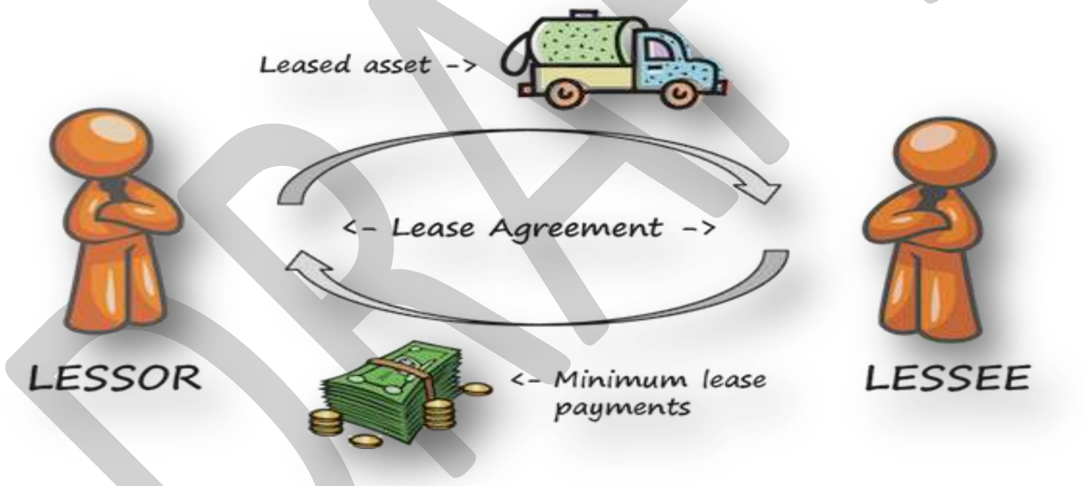
[1] References to IPSAS 13 or any other IPSAS shall be taken as meaning 'as adopted by the Maltese Government'

A. Lease Defined

1. A ***lease*** is an agreement whereby a lessor conveys to the lessee, in return for a *payment* or a *series of payments* (minimum lease payments), the *right to use* an asset for an agreed period of time (lease term). In other words it is a contract between a lessee and a lessor for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right of the use of the asset to the lessee for an agreed period of time *in return* for the payment of specified rental payments.

Lessor: the owner of an asset who loans out this asset to a person or entity (lessee) against rental payments.
Lessee: the person or entity making use of the loaned asset received from the lessor, against rental payments.



2. **Determining whether an arrangement contains a lease**

2.1 The determination of whether an arrangement contains a lease should be based on the substance of the arrangement, rather than its legal form, that is its commercial reality, rather than its strict legal form.

2.2 An asset may be leased to a lessee without the transfer of legal title at the end of the lease term but the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life. Thus, such asset should be included in the lessee's financial statements.

2.3 For example a department may choose <u>not</u> to buy photocopiers for the office but get them <u>on loan</u> (that is leased) from the owner of the photocopiers (lessor), against a monthly payment (rental payments), until the photocopiers are no longer fit for use (that is the major part of their economic life has been used up). The photocopiers will still be owned by the lessor (as owner has legal title) but they will be entirely used by the lessee (the department). Therefore in this case the photocopiers are <u>assets of the department</u> (as the department is reaping the full benefits from their use) and should be shown as an asset on the department's financial report (the lessee's financial statements).

2.4 Examples of leases in Central Government:

Leasing of Motor Vehicles

Leasing of PCs

Leasing of Photocopiers

Leasing of Buildings

Leasing of Medical Equipment

B. Impact of IPSAS 13 Implementation

1. One of the major differences between the ***current cash-based accounting system*** and ***accruals-based accounting*** is the fact that currently leased asset expenses are expensed when there is a cash outlay.

2. The implementation of this standard compliments the Property, Plant and Equipment standard; in fact the benefits associated with the implementation of both these standards, the required changes in processes and the challenges foreseen as a result of this implementation are very similar (please refer to '*IPSAS 17 PP&E as adopted by MG' Guidelines*).

C. Classification of Leases

1. There are two types of leases:
   - Finance leases
   - Operating leases

2. The **classification** of leases has to be performed at the **inception of the lease.**

<u>Commencement date</u> and <u>inception date</u>.

- The <u>commencement date</u> is the date from which the lessee is entitled to exercise its right to use the asset and therefore when the lease will be initially recognised in the accounting records and when depreciation commences. Thus, it is typically the date of the lease when the lessee takes <u>possession</u> of the leased asset.

- The <u>inception date</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. Thus, it is typically the date on which the <u>lease agreement is signed</u> by both parties and becomes legally binding.

For example: if a lessee signs a lease agreement on 1 January 2013 but cannot start using the lease until 1 June 2013, the <u>inception date</u> would be <u>1 January 2013</u> but the <u>commencement date</u> would be <u>1 June 2013</u>. The asset and lease obligation would <u>not</u> be recognised until the commencement date of <u>1 June 2013</u>.

3. The classification of a lease does <u>not</u> depend on where the <u>legal ownership</u> of the leased asset lies, but rather on the extent to which <u>the risk and rewards</u> incidental to ownership of the asset have been transferred from the lessor to the lessee.

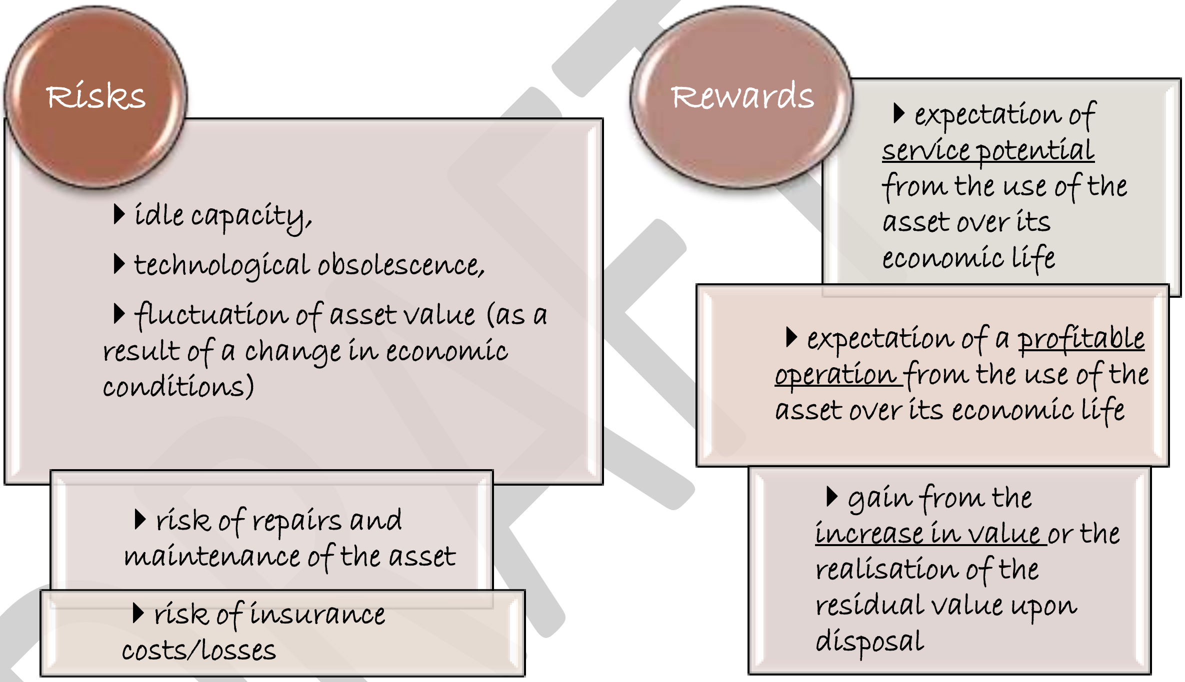
4. Any <u>revised</u> agreement should be treated as a <u>new</u> agreement over its term. In the case of a renewal or extension of the lease, where the lease arrangement has been reassessed, the accounting for the lease should be applied from the inception of the renewal or extension period.

5. In contrast, the following do <u>not</u> lead to a new classification of a lease for accounting purposes:
   - changes in estimates (eg. of economic life or residual value of the property) or
   - changes in circumstances (eg. default by the lessee).

6. **Finance Leases**: A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership.

6.1 In a finance lease, legal title may or may not be eventually transferred. Thus, although legal title of a leased asset may not transferred to a lessee, but the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life, such asset should be included in the lessee's financial statements.

6.2 The risks and rewards that are considered incidental to ownership include (but are not limited to) the following:



6.3 **Situations and Indicators of a Finance Lease:**

6.3.1 The lease transfers ownership of the asset to the lessee at the end of the lease term;

6.3.2 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;

6.3.3 The lease term is for a major part of the asset's economic life of the asset, even if title is not transferred;

6.3.4 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;

6.3.5 The leased asset is so <u>specialised</u> that it could only be used by the lessee without major modifications being made;

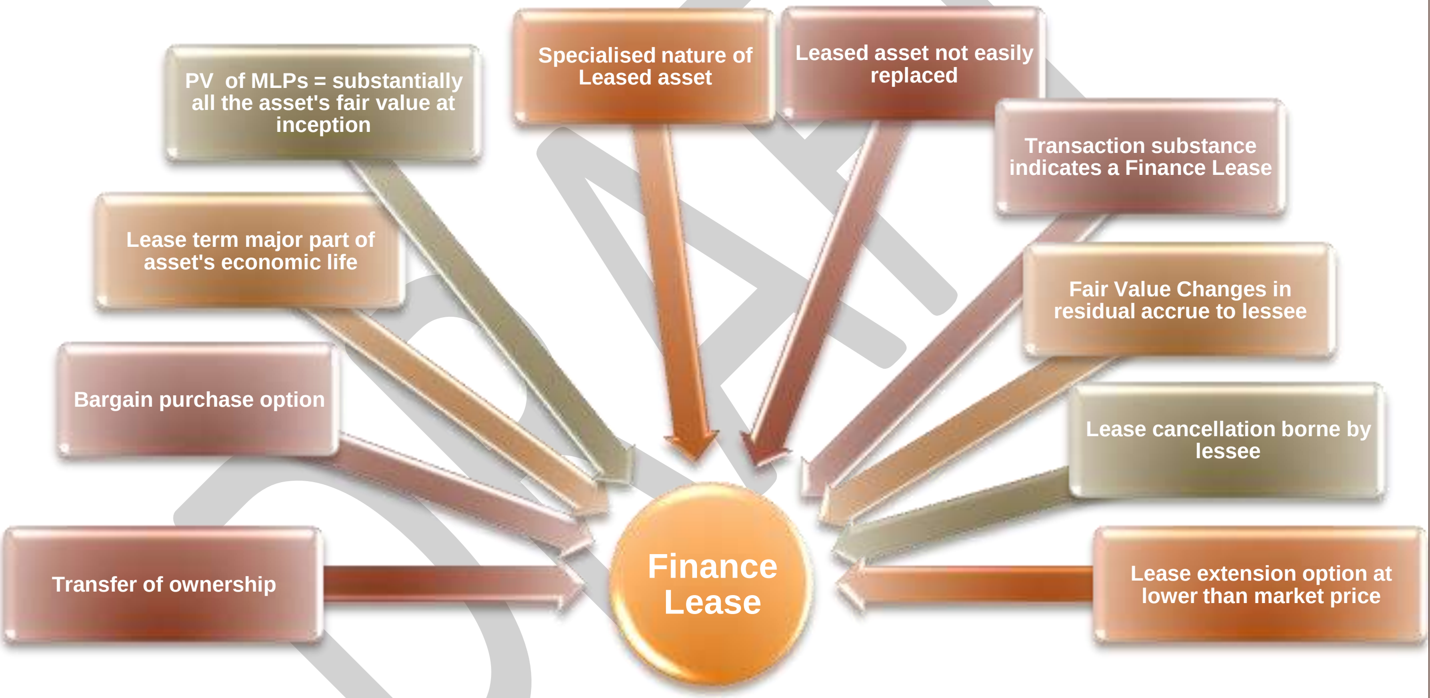
6.3.6 The leased asset cannot easily be replaced by another asset.

6.4 **Indicators that could also lead to lease being classified as finance lease (but these are not always conclusive) are:**

6.4.1 If the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

6.4.2 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);

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



6.5 These indicators are intended to assist as a guide in the decision-making process, but may not be conclusive. A department should therefore not follow these indicators blindly, but it is important that it considers the overall <u>substance of the lease agreement</u> for each of its leases.

6.6 A lease is classified as an operating lease, even if one or more of these indicators are present, if it is clear from other factors that the risks and rewards of ownership are not transferred to the lessee.

Finance or Operating lease? - The deciding factor is the extent to which risks and rewards incidental to ownership of an asset lie with either the lessor or lessee.

6.7 **Minimum Lease payments (MLPs)**

6.7.1 When a lessor contracts a lessee, the lessee agrees to pay the lessor a specific periodic amount, or lease rate, for a predetermined amount of time.

6.7.2 For example, a department decides to lease equipment at a lease rate of € 2,000 per month for 5 years. The lease payments would be the lease rate multiplied by the number of payment periods. In this case they would total € 2,000 x 5 years x 12 months = € 120,000.

The **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:

- For a lessee – any amounts guaranteed by the lessee or by a party related to the lessee (i.e. a financial commitment, which will be assumed by another party [guarantor] should lessee be unable to honour commitment).

- For a lessor – any residual value** guaranteed by the lessee, a party related to the lessee or a third party unrelated to the lessor who is financially capable of discharging its obligations under the guarantee.

(*Contingent Rent: amount that is paid as part of lease payments but is not fixed or agreed in advance at the inception of lease but dependent on some future event. For example the lessee may agree to pay additional rental payments based on the use of the leased asset or on financial benefits derived from the leased asset. As stated above these are excluded from the minimum lease payments and are accounted as expense/income in the period in which they are incurred/earned.
**The Residual Value is the residual, or remaining, value of the leased asset at the end of the lease agreement).

6.7.3 Therefore, MLPs are the lowest total amount that a lessee can expect to pay during the term of a lease once other costs (for example, utilities and insurance) have been accounted for.

6.7.4 MLPs are expressed as the present value of lease payments at the outset of a lease contract.

Present Value (PV) is the total amount that a series of future payments is worth now. For example, when you borrow money, the loan amount is the present value to the lender.

6.7.5 Example 1: Present Value of Minimum Lease Payments

A Government Department entered into a lease agreement on 1 April 2013 to lease a machine for a period of three years. The *monthly* lease payment is €6,000 payable in arrears beginning 30 April 2013 and the rate implicit in the lease* is 4% per annum. What is the Present Value of Minimum Lease Payments due?

*(*rate implicit in the lease: an interest rate not explicitly stated in an agreement but deducible from the present value of the lease payments, representing the cost of borrowing)*

Solution

The present value may be calculated by:

i) using a formula

PV of minimum lease payments:

$$\text{PV of MLP} = pmt \text{ x } \frac{1}{(1+r)^n}$$

pmt = payment made each period
r = rate implicit in the lease
n = total number of payment periods

PMT	€6,000
r	0.00333333% (4%/12)
n	36 (3x12)
PV	**€203,225**

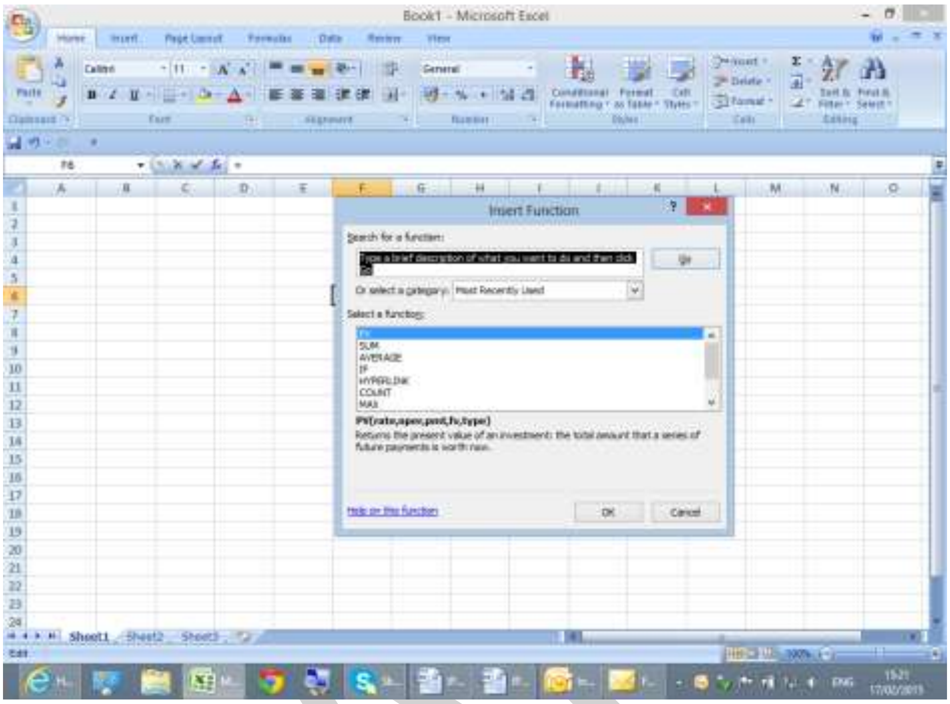
Note that the lease is payable on a **monthly basis**, therefore the **interest rate** and **period** also need to be calculated monthly.

ii) using a table

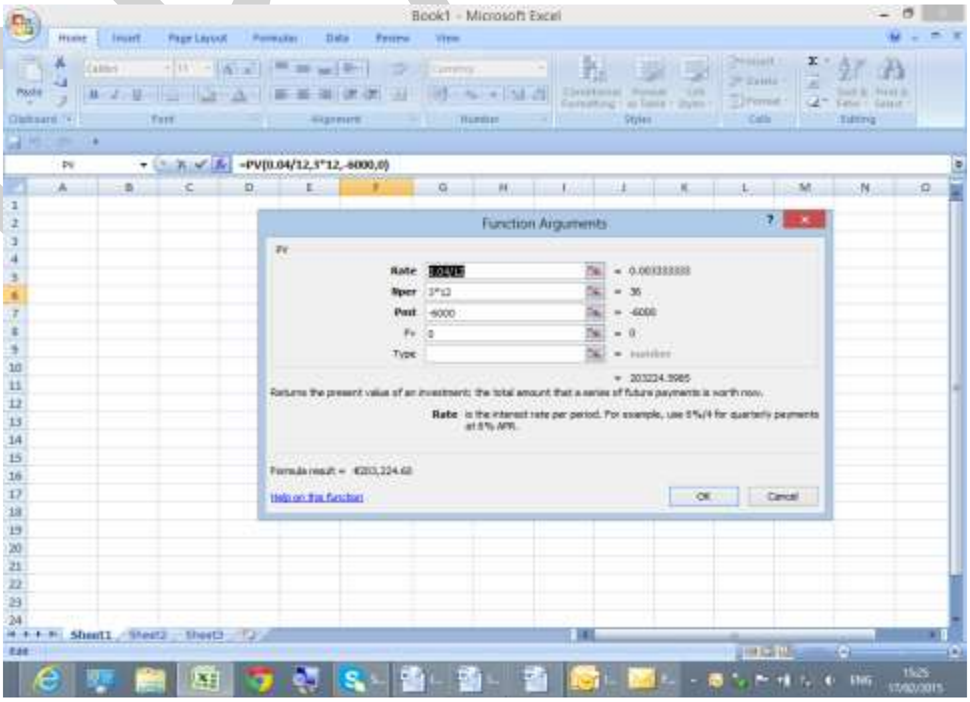
n	Period	Monthly Payments	r (4%/12)	(1+r)	$(1+r)^n$	Discount factor $\frac{1}{(1+r)^n}$	PV (Payments x Discount Factor)
1	end of April	6,000	0.0033333	1.0033333	1.0033333	0.9966777	5,980.07
2	May	6,000	0.0033333	1.0033333	1.0066778	0.9933665	5,960.20
3	June	6,000	0.0033333	1.0033333	1.0100334	0.9900663	5,940.40
4	July	6,000	0.0033333	1.0033333	1.0134001	0.9867770	5,920.66
5	August	6,000	0.0033333	1.0033333	1.0167781	0.9834987	5,900.99
6	September	6,000	0.0033333	1.0033333	1.0201674	0.9802313	5,881.39
7	October	6,000	0.0033333	1.0033333	1.0235680	0.9769747	5,861.85
8	November	6,000	0.0033333	1.0033333	1.0269799	0.9737289	5,842.37
9	December	6,000	0.0033333	1.0033333	1.0304031	0.9704939	5,822.96
10	January	6,000	0.0033333	1.0033333	1.0338378	0.9672697	5,803.62
11	February	6,000	0.0033333	1.0033333	1.0372839	0.9640562	5,784.34
12	March	6,000	0.0033333	1.0033333	1.0407415	0.9608534	5,765.12
13	April	6,000	0.0033333	1.0033333	1.0442107	0.9576611	5,745.97
14	May	6,000	0.0033333	1.0033333	1.0476914	0.9544795	5,726.88
15	June	6,000	0.0033333	1.0033333	1.0511837	0.9513085	5,707.85
16	July	6,000	0.0033333	1.0033333	1.0546876	0.9481480	5,688.89
17	August	6,000	0.0033333	1.0033333	1.0582033	0.9449980	5,669.99
18	September	6,000	0.0033333	1.0033333	1.0617306	0.9418585	5,651.15
19	October	6,000	0.0033333	1.0033333	1.0652697	0.9387294	5,632.38
20	November	6,000	0.0033333	1.0033333	1.0688206	0.9356107	5,613.66
21	December	6,000	0.0033333	1.0033333	1.0723833	0.9325024	5,595.01
22	January	6,000	0.0033333	1.0033333	1.0759580	0.9294043	5,576.43
23	February	6,000	0.0033333	1.0033333	1.0795445	0.9263166	5,557.90
24	March	6,000	0.0033333	1.0033333	1.0831430	0.9232392	5,539.43
25	April	6,000	0.0033333	1.0033333	1.0867534	0.9201719	5,521.03
26	May	6,000	0.0033333	1.0033333	1.0903759	0.9171149	5,502.69
27	June	6,000	0.0033333	1.0033333	1.0940105	0.9140680	5,484.41
28	July	6,000	0.0033333	1.0033333	1.0976572	0.9110312	5,466.19
29	August	6,000	0.0033333	1.0033333	1.1013161	0.9080045	5,448.03
30	September	6,000	0.0033333	1.0033333	1.1049871	0.9049879	5,429.93
31	October	6,000	0.0033333	1.0033333	1.1086704	0.9019813	5,411.89
32	November	6,000	0.0033333	1.0033333	1.1123660	0.8989847	5,393.91
33	December	6,000	0.0033333	1.0033333	1.1160739	0.8959980	5,375.99
34	January	6,000	0.0033333	1.0033333	1.1197941	0.8930213	5,358.13
35	February	6,000	0.0033333	1.0033333	1.1235268	0.8900544	5,340.33
36	March	6,000	0.0033333	1.0033333	1.1272719	0.8870974	5,322.58
	Total						**203,224.60**

iii) using the Function Arguments on Excel

- Click on *fx;* then from 'insert function' click on PV



- Fill in the details in 'Function Arguments' based on the information available and the result will be displayed (€ 203,225)



6.7.6 Example 2

The Government Printing Press has leased specialised printing equipment from a third party. The useful life of the equipment is 6 years and the lease term is 5 years. The fair value of the equipment is €500,000 and the present value of minimum lease payments made by the department amounts to €450,000.

The equipment is specifically designed for the operations of the department and the lease contract contains a provision which allows the department to either extend the lease at much lower rates or purchase the equipment at the end of 5 years for €70,000. The fair value of the equipment at the end of the lease term is expected to be €90,000.

Is this a Finance Lease or an Operating Lease?

Solution

This is definitely a finance lease as indicated by the following:

i) The lease term is for the *major* part of the equipment useful life (lease term 5 years, useful life 6 years - 83.3%);

> IPSAS Team Note:
>
> There is no clear cut threshold as to what is 'a major part of the economic life of the asset', although **approximately 75%** is considered reasonable as common practice. However, an entity should **consider all other relevant factors** when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.

ii) The lease contains a bargain purchase option *('purchase the equipment at the end of 5 years for €70,000'*);

> IPSAS Team Note:
>
> If the department has a policy of **returning all leased assets** at the end of the lease term, regardless of the price, this indicator will not be present – even if the price at the date that the option is expected to be exercised is significantly lower than the fair value.

iii) The present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset (*fair value of the equipment is €500,000 and the present value of minimum lease payments amounts to €450,000* - 90%);

IPSAS Team Note:

There is no clear cut threshold indicating what percentage is considered 'substantial', although **approximately 90% of the fair value of the leased asset** is considered reasonable as common practice. However, an entity should **consider all other relevant factors** when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.

iv) The equipment is customised and cannot be used by another party without significant modifications ('leased *specialised* printing equipment'*).*

6.7.7 Example 3

A Government Department leases a vehicle with a total economic life of 5 years from a third party for a period of 4 years. The department has the option to continue with the lease for another year, without payment during this period. It is reasonable certain that this option will be exercised.

Is this a Finance Lease or an Operating Lease?

Solution

There are two indicators that this lease agreement is a finance lease:

i) The department has the ability to continue with the lease for another year at a rent lower than market rent; and
ii) The lease term will be 5 years in total, which is equivalent to the economic life of the vehicle.

This lease will therefore be classified as a finance lease at the inception of the agreement.

6.7.8 Example 4

On 1 January 2013 department X entered into a lease agreement with Zero Limited in respect of a printing machine. The terms of the lease were as follows:

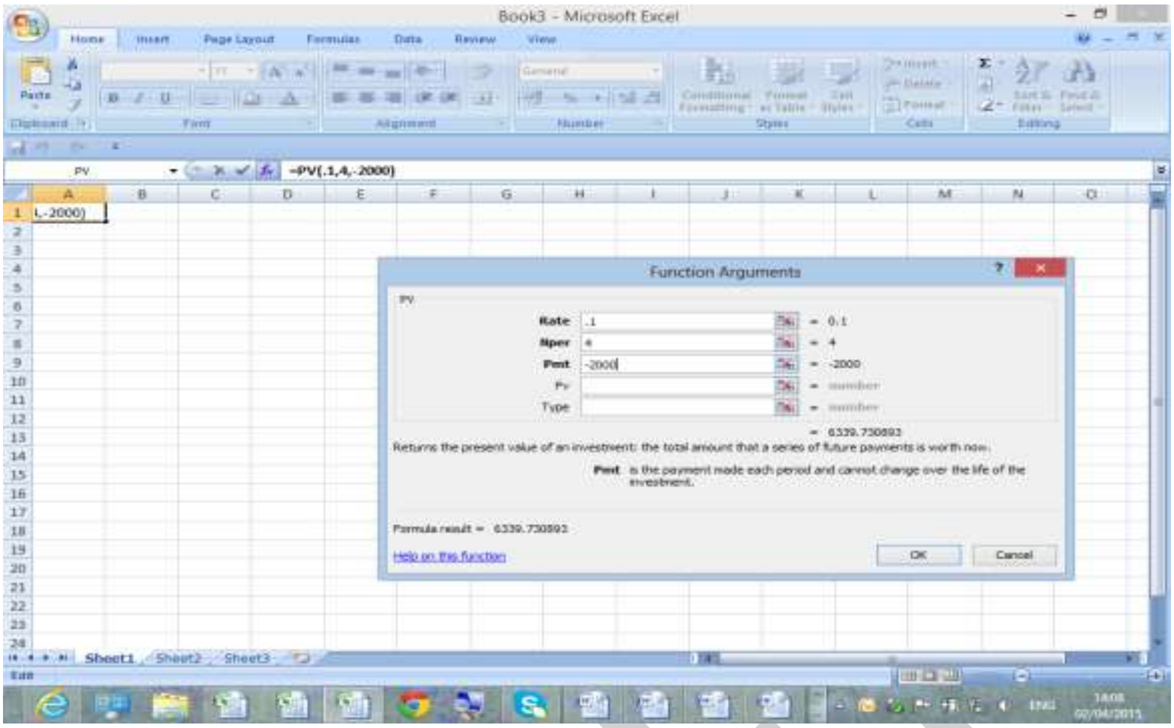
- Department X had to pay an initial deposit of €1,600 and four further payments of €2,000 each at 31 December of years 2013, 2014, 2015 and 2016.
- Department X will be responsible for the insurance, repairs and maintenance of the printing machine.
- Department X has the option to buy the printing machine for € 500 at the end of the lease.
- Department X has the right to extend the lease for one year at end of the lease term by paying €800.
- The printing machine has an expected useful life of five years at which time it will have a nil residual value.
- The estimated residual value of the printing machine at the end of the lease term is €1,500.
- The interest rate implicit in the lease is 10%.
- The cash price of the printing machine was €8,000.
- The printing machine is specially designed for the department's operation.
- The department decided to exercise the option and to purchase the printing machine at the end of the lease term.
- The market rent for machines similar to the printing machine is around € 2,000 per year.

Is this a Finance Lease or an Operating Lease?

Solution

The lease between Department X and Zero Limited is a **finance lease** because:

i) At the inception of the lease the present value of the minimum lease payments is equal to the deposit €1,600 plus €6,340 (the PV of €2,000 payment per period over four years – see below) = €7,940.



ii) The present value of the minimum lease payments, amounting to €7,940, amounts to substantially all of the fair value (€8,000) of the leased asset

iii) The lease term, which is four years, is for the major part of printing machine's economic life of five years and there is no doubt that Department X enjoys most of the future benefits and only an immaterial residual value would be returned to Zero Limited at the end of the lease.

iv) Department X is responsible for the insurance, repairs and maintenance of the asset and this indicates that Department X is in substance the owner of the asset.

7. **Operating Leases**: A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership. Therefore, a lease other than a finance lease is an operating lease.

7.1 Example 1

A Government Department decided to hire (lease) an executive car while its car is being repaired. Leases of this type are usually referred to as operating leases as indicated by the following:

❖ A lease of this nature is for a short period of time compared with the car's useful life.

- The lessor will expect to lease it to many different lessees during the car’s useful life.
- The lessor rather than the lessee will be responsible for maintenance.

7.2 Example 2

A Government Department decided to lease equipment for 2 years at the rate of €10,000 per year. This equipment was specifically needed for a particular project. The department will return the equipment at the end of the 2 years period and there is no option to either purchase the asset at a lower price or extend the lease term. The useful life of the equipment is 4 years.

The lease should be treated as an operating lease because:

- The lease agreement does not contemplate a transfer of ownership to lessee at the end of the lease term.
- The lease term is only half as long as the total useful life of the asset.
- There is no bargain purchase option (i.e. option to buy the asset at a lower price at the end of the lease term).

8. **Leases of Land and Buildings**: When a lease includes both the land and building elements, an entity assesses the classification of each element as a finance lease or an operating lease separately.

8.1 Land has an indefinite economic life and therefore the land element is normally classified as an operating lease (unless legal title is expected to pass to the lessee by the end of the lease term).

8.2 The building element may be classified as a finance lease or an operating lease. For example there are Government office buildings which are occupied under an operating lease agreement. In these instances the contract allows for the use of the building, but does not convey rights of ownership of the said premises.

8.3 A building may be classified as a finance lease and the land as an operating lease.

8.3.1 On initial recognition, the lease payments should be allocated between the land and the building based on the fair values of each element. If payments cannot be allocated, the entire lease is classified as a finance lease, unless the lease contract is clearly an operating lease, e.g. where the building is leased for a significant shorter period than its economic life. In instances where the lease payment amount that would be allocated to land is immaterial, both land and buildings can be treated as a single asset for classification purposes and the economic life of the asset would be based on the economic life of the building.

8.3.2 Where lessee's interest in the property is classified as an investment property in terms of IPSAS 16 – Investment Property, separate measurement of land and buildings is not required and it is accounted for under the fair value model. In such a situation, the lease is accounted for as if it was a finance lease. Where subsequent events change the nature of the lessee's property interest, the lessee should carry on accounting for the property interest as a finance lease, even though it is no longer classified as investment property.

D. Leases in the Financial Statements of Lessees

1. **Finance Lease**

1.1 Initial Recognition: At the commencement of the lease term, lessee should *capitalise the finance lease asset* and set up *a lease liability* for the value of the asset recognised, each determined at the inception of the lease, at the *lower* of the *fair value* of the asset and the *present value of the minimum lease payments.*

1.2 The present value of the minimum lease payments is essentially the lease payments over the life of the lease discounted to present value. The discount rate for calculating the present value of the minimum payments is the *interest rate implicit in the lease*, if this practical to determine; if not, the lessee's *incremental borrowing rate* shall be used (i.e. governmental lending rate).

1.3 Any initial direct costs of the lessee are added to the amount recognised as an asset. Such costs are often incurred in connection with securing or negotiating a lease. Only those costs which are *directly attributable* to activities performed by the lessee *to obtain a finance lease* should be added to the amount recognised as an asset, if this distinction for other assets is made.

1.4 It is not appropriate to show liabilities for leased assets as deductions from the leased assets. Additionally, distinction should be made between current and non-current lease liabilities.

1.5 The accounting entry is as follows:

Debit	Property, Plant and Equipment
Credit	Finance Lease Liability (Leased Asset)

1.6 The Implicit Interest Rate is the discount rate that, at the inception of the lease, causes the *aggregate present value* of:

Minimum lease payments and the unguaranteed residual value to be equal to the sum of the fair value of the leased asset and any initial direct costs of the lessor.

1.7 Therefore the Implicit Interest Rate is achieved when

PV of Minimum lease payments + PV of Unguaranteed residual value
= FV of leased asset + lessor's initial direct costs

1.8 If a lease agreement does not identify the interest rate implicit in the lease, the correct rate has to be found by trial and error.

1.9 Example 1 - Purchase of Motor Vehicle (finance lease)

- Fair Value of Motor Vehicle (at lease inception) is € 25,000
- Annual Lease Payments is € 5,429 (payable in arrears)
- Lease Term is 4 years
- Guaranteed Residual Value (after 4 years) is € 10,000
- Lease agreement does not specify the interest rate implicit in the lease.
- What is the implicit rate of interest if:
  a) The Department's incremental borrowing rate is 7% p.a.
  b) Financial institutions are advertising rates between 7.5% and 10%

Solution:

$$\text{PV of MLP} = pmt \text{ x} \frac{1}{(1+r)^n}$$

a) 7%:

Year 1 = €5,429 = $\frac{1}{(1+0.07)^1}$ = €5,074

Year 2 = €5,429 x $\frac{1}{(1+0.07)^2}$ = €4,742

Year 3 = €5,429 x $\frac{1}{(1+0.07)^3}$ = €4,432

Year 4* = €15,429 x $\frac{1}{(1+0.07)^4}$ = €11,771

∴ PV of MLP = €5,074 + €4,742 + €4,432 + €11,771 = €26,018:

the PV of MLP > FV therefore this is <u>not</u> the implicit interest rate

* Note that the **guaranteed residual value** is to be added with the **annual lease payment**

b) 8.5%:

Year 1 = €5,429 x $\frac{1}{(1+0.085)^1}$ = €5,004

Year 2 = €5,429 x $\frac{1}{(1+0.085)^2}$ = €4,612

Year 3 = €5,429 x $\frac{1}{(1+0.085)^3}$ = €4,250

Year 4* = €15,429 x $\frac{1}{(1+0.085)^4}$ = €11,133

∴ PV of MLP = €5,004 + €4,612 + €4,250 + €11,133 = €24,999:

the PV of MLP = FV therefore this is the implicit interest rate

∴ 8.5% is the <u>implicit interest rate</u> where PV of MLP = FV of asset

1.10 <u>Subsequent measurement:</u> after initial recognition, the *minimum lease payments* should be apportioned between the *finance charge (interest)* and the reduction of the *outstanding lease liability*.

1.11 When a department makes a rent payment, in effect it is making a <u>capital repayment</u> (that is against the lease obligation) and an <u>interest payment</u>. The impact of this will need to be shown in the financial statements.

1.12 The finance cost (the interest payment) will show on the Statement of Financial Performance and the reduction of the outstanding liability will be disclosed on the Statement of Financial Position.

1.13 The basic accounting entry for *minimum lease payments paid to the lessor* is recorded as follows:

Debit	Finance Lease Liability (Leased Asset)
Credit	Cash

1.14 <u>Allocating the Finance Charge:</u> The total finance charge should be allocated to accounting periods *during the lease term* to produce a constant periodic rate of interest (interest rate implicit in the lease) on the remaining liability.

1.15 In practice, the *actuarial method* is frequently used to work out the allocation. The actuarial method of accounting for a finance lease allocates the interest to the period it actually relates to, that is the finance cost is higher when the amount outstanding is greatest, but as the amount gets repaid, interest payments become lower. To allocate the interest to a specific period, the interest rate implicit within the lease agreement is required.

1.16 The actuarial method is in fact the best method for allocating the finance charge. It derives from the assumption that the interest charged by a lessor will equal the rate of return desired, multiplied by the amount of capital it has invested:

1.16.1 At the *beginning* of the lease the capital invested is *equal to* the fair value of the asset (less any initial deposit paid by the lessee).

1.16.2 This amount will decrease as each investment is paid. It follows that the interest accruing is higher during the early part of the lease term, and gradually decreases as capital is repaid.

1.17 Example – Allocating the Finance Charge

On 1 January 2014, the Government Printing Press bought a printing machine from a 3rd party under a finance lease. The cash price of the machine was €8,096 while the amount to be paid was €10,500. The agreement required the immediate payment of a €2,100 deposit with the balance being settled in four equal annual instalments commencing on 31 December 2014. The charge of €2,404 represents interest of 15% per annum, calculated on the remaining balance of the liability during each accounting period. Depreciation on the machine is to be provided for at the rate of 20% per annum on a straight line basis assuming a residual value of nil.

Calculate the breakdown of each instalment between interest and capital, using actuarial method.

Solution

- Annual instalment is €2,100.
- Interest is calculated as 15% of the outstanding capital balance at the beginning of each year.
- The outstanding capital balance decreases each year by the capital element comprised in each instalment.
- The outstanding capital balance at 1 January 2014 is €5,996 (€8,096 fair value less €2,100 deposit).
- The finance cost decreased with the decrease in outstanding liability.

	Total €	Capital €	Interest €
Capital Balance 1 Jan 2014		5,996	
Interest = €5,996 x 15%	2,100	1,201	899
Capital Balance 1 Jan 2015		4,795	
Interest = €4,795 x 15%	2,100	1,381	719
Capital Balance 1 Jan 2016		3,414	
Interest = €3,414 x 15%	2,100	1,588	512
Capital Balance 1 Jan 2017		1,826	
Interest = €1,826 x 15%	2,100	1,826	274
	8,400		2,404
Capital Balance 1 Jan 2018		–	

1.18 Depreciation expense and impairment: the lessee should charge the depreciation expense related to the assets held under finance leases.

1.19 An asset under a finance lease should be depreciated over the shorter of:

a) The lease term or

b) Its useful life

if there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term.

1.20 The policy of depreciation adopted should be consistent with similar non-leased assets and calculations should follow the bases set out in IPSAS 17 Property, Plant and Equipment.

1.21 Where applicable, the entity should assess whether the asset has become impaired, by applying the relevant impairment tests in accordance with the standards on impairment of assets (refer to IPSAS 21 and IPSAS 26).

1.22 Example – Depreciation Expense

On 1 January 2005 Department Y entered into a lease agreement to lease an asset with an estimated useful life of five years. The asset will be returned to AZZ Ltd, the leasing company, after a lease period of five years. Annual rentals of €6,500 are payable from 31 December 2005, in arrears. The asset is expected to have no residual value at the end of its life. At lease inception the asset had a fair value of €24,640. A finance cost of 10% is included in the annual rentals.
Show the accounting treatment of the lease in the financial statements of the lessee for the year ended 31 December 2010.

Solution
This lease is a finance lease as the Department is enjoying the rewards from using the asset for five years, the asset's estimated useful life.

i) **Initial recognition:** capitalise the finance lease asset and set up a lease liability for the value of the asset recognised

Debit Property, Plant & Equipment	€24,640
Credit Finance Lease Obligations	€24,640

ii) **Subsequent measurement:** Depreciation

Debit Depreciation Expense (€24,640/5)	€4,928
Credit Accumulated Depreciation	€4,928

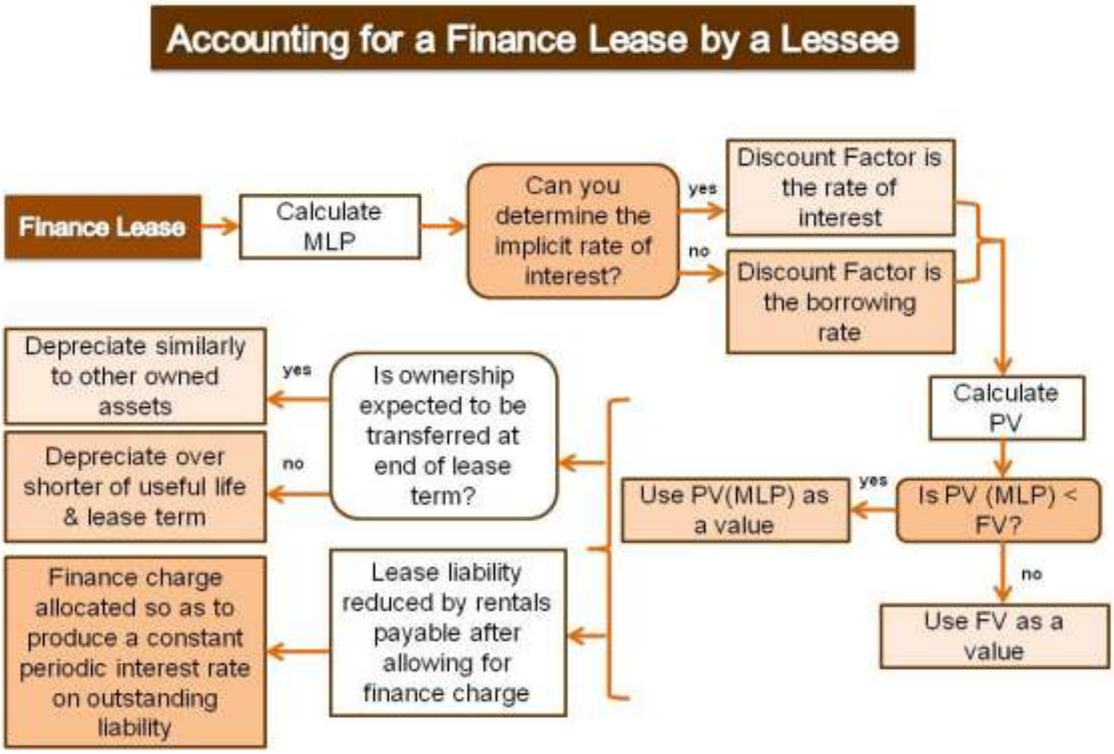
iii) **Subsequent measurement:** Lease rental/interest

Year	B/fwd (a) €	Interest (10%) (b) €	Capital (c) €	Rental (d) €	C/fwd (e) €
		(a) x (b)	-(b) - (d)		(a) - (c)
1	24,640	2,464	4,036	- 6,500	20,604
2	20,604	2,060	4,440	- 6,500	16,164
3	16,164	1,616	4,884	- 6,500	11,281
4	11,281	1,128	5,372	- 6,500	5,909
5	5,909	591	5,909	- 6,500	0
		7,860	**24,640**	**- 32,500**	

- The rental payments above include a capital and an interest portion.
- The finance lease obligation is subject to a finance cost of 10%, equivalent to € 2,464 in the first year.
- Therefore the first rental payment of € 6,500 consists of a € 2,464 finance (interest) charge and € 4,036 repayment of capital.
- As the amounts are repaid, the interest payments become lower, and in the fifth year the interest charge amounts to € 591.
- In the fifth year, the amount is fully paid.

Debit Finance Lease Charge	(€2,464+€2,060+€1,616+€1,128+€591)= € 7,860
Debit Finance Lease Liability	(€4,036+€4,440+€4,884+€5,372+5,909)= €24,640
Credit Cash	€6,500 x 5 = €32,500

1.23 Accounting for a Finance Lease by a Lessee



1.24 Accounting for a Finance Lease by a Lessee – Example 1

Mater Dei Hospital entered into a lease agreement on 1 April 2013 to lease a specialised machine for a period of 3 years. Useful life of the machine is 4 years. The yearly lease payment is €60,000 payable in arrears beginning 1 April 2014 and the rate implicit in the lease is 5%. In addition, Mater Dei Hospital has to pay a contingent rent based on 2% of its revenue.

Mater Dei Hospital's revenues over the three years were as follow:

Year 1	€200,000
Year 2	€250,000
Year 3	€150,000

After the lease term, the ownership of the machine is to be transferred to the Hospital.

The fair value of the machine is €189,000.

Show the accounting treatment of the lease in the accounts of the *lessee* to the year ended 1 April 2016.

Solution:

Step 1: Determine the Present Value of Minimum Lease Payments

PV of minimum lease payments:

$$\text{PV of MLP} = pmt \text{ x} \frac{1}{(1+r)^n}$$

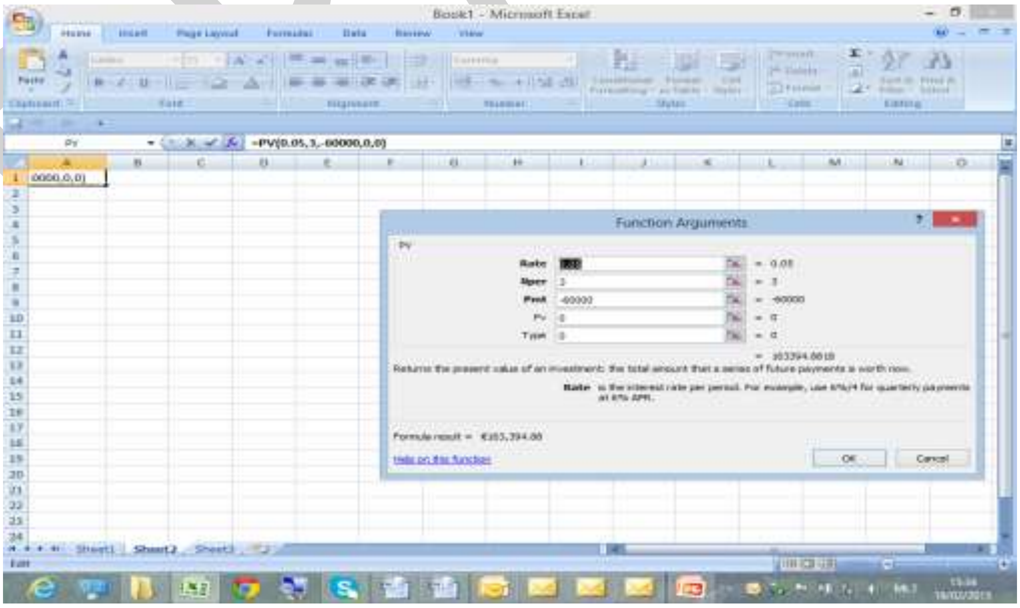
pmt = payment made each period
r = rate implicit in the lease
n = total number of payment periods

Year 1 = €60,000 x $\frac{1}{(1+0.05)^1}$ = €57,143

Year 2 = €60,000 x $\frac{1}{(1+0.05)^2}$ = €54,422

Year 3 =€60,000 x $\frac{1}{(1+0.05)^3}$ = €51,830

∴ **PV of MLP** = €57,143 + €54,422 + €51,830 = **€163,395** **OR:**



Step 2: Determine the amount at which the asset and liability would be recognised in the records of the lessee.

Remember that the **lease asset and liability** should be recognised at the **lower** of the **fair value of the leased asset** and the **present value of the minimum lease payments due.**

∴ In this case, the amount to be recognised is **€163,395** (as the **fair value** is **€ 189,000**)

Step 3: Draw up an amortisation table to split the lease payments between the interest and capital portions as follows:

Date	Payment	Interest*	Capital**	Balance
1 April 2013				€163,395
1 April 2014	€60,000	€8,170 (5% x €163,395)	€51,830 (€60,000 - €8,170)	€111,565
1 April 2015	€60,000	€5,578 (5% x €111,565)	€54,422 (€60,000 - €5,578)	€57,143
1 April 2016	€60,000	€2,857 (5% x €57,143)	€57,143 (€60,000 - €2,857)	0
Total	**€180,000**	**€16,605**	**€163,395**	

***Interest**: total outstanding balance x rate implicit in the lease

****Capital**: payment received less interest element

Contingent rent is not added in the amortisation table. This should be expensed in the period when incurred, therefore it will not form part of the finance lease liability payments.

Note: If we take the same example above but assume that the lease payments were made on a *monthly* basis, the amortisation table will need to be drawn up on a *monthly* basis.

Step 4: Recognise the finance lease asset and liability.

Accounting entries will be as follows:

Year 1	Debit	Credit
	€	€
Finance lease asset	163,395	
Finance lease liability		163,395
Recognising the asset leased under a finance lease		

The journal entries under subsequent measurement for year 1 to 3 will be as follow:

Year 1	Debit	Credit
	€	€
Finance lease liability	51,830	
Interest expense	8,170	
Lease expense (contingent rent - €200,000 x 2%)	4,000	
Cash (actual payment)		64,000
Payment of first instalment and contingent rent		

Year 1	Debit	Credit
	€	€
Depreciation (€163,395/3yrs)	54,465	
Accumulated depreciation		54,465
Recognising depreciation on the asset leased for year 1		

Year 2	Debit	Credit
	€	€
Finance lease liability	54,422	
Interest expense	5,578	
Lease expense (contingent rent - €250,000 x 2%)	5,000	
Cash (actual payment)		65,000
Payment of second instalment and contingent rent		

Year 2	Debit	Credit
	€	€
Depreciation (€163,395/3yrs)	54,465	
Accumulated depreciation		54,465
Recognising depreciation on the asset leased for year 2		

Year 3	Debit	Credit
	€	€
Finance lease liability	57,143	
Interest expense	2,857	
Lease expense (contingent rent - €150,000 x 2%)	3,000	
Cash (actual payment)		63,000
Payment of third instalment and contingent rent		

Year 3	Debit	Credit
	€	€
Depreciation (€163,395/3yrs)	54,465	
Accumulated depreciation		54,465
Recognising depreciation on the asset leased for year 3		

1.25 Accounting for a Finance lease by a Lessee – Example 2

A Government Department enters into a lease to lease an item of equipment with the following terms:

- Inception of lease: 1 January 2014
- Term: 5 years at €2,100 per annum payable in advance
- Fair Value: €8,400
- Useful life: 8 years
- Interest rate implicit in the lease: 12%

Show the accounting treatment of the lease in the accounts of the *lessee* to the year ended 31 December 2014.

Solution

Working		**€**
1 Jan 2014	Liability b/d	8,400
1 Jan 2014	Instalment 1 (in advance)	(2,100)
		6,300
1 Jan – 31 Dec 2014	Interest (12%x €6,300)	756
31 Dec 2014	Liability c/d	**7,056**

Statement of Financial Performance (extract)	
	€
Depreciation (€8,400/5*)	1,680
Finance Costs (refer to working)	756
**Shorter of lease term and useful life*	

Statement of Financial Position (extract)	
	€
Non-current assets	
Equipment (€8,400 - €1,680)	6,720
Non-current liabilities	
Finance lease liability (total due of 7,056 less current 2,100 below)	4,956
Current liabilities	
Finance lease liability (due on 1 January 2015)	2,100

2. **Operating Lease**

2.1 In the case of an Operating Lease, no asset is recognised, as the risks and rewards incidental to ownership are not transferred to the lessee. Consequently, these lease payments should be written off as an expense in the Statement of Financial Performance on a straight line basis over the lease term, even if the payments are not made on such a basis, unless another systematic and rational basis is justified by the circumstances.

2.2 Instances where straight-line method will not be required:

- Rental agreement is for an indefinite period;
- Rental agreement is on a month-to-month basis; and
- There is no escalation of the lease payments (e.g. lease payments change according to a price index).

Note: Payments for services such as insurance and maintenance costs should be separately recognised and disclosed in the period they occur.

> **Note** that any **difference** between the **actual lease payments** and the **straight-lined amounts** will be recognised as **operating lease assets** or **liabilities** in the Statement of Financial Position.

Operating lease asset

- **actual amount paid > straight-lined amount**

Operating lease liability

- **actual amount paid < straight-lined amount**

2.3 Operating Leases - Example 1

On 1 October 2014 a department entered into an agreement to lease a machine that had an estimated life of 10 years. The lease period is for four years with annual rentals of €5,000 payable in advance from 1 October 2014. The machine is expected to have a nil residual value at the end of its life. The machine had a fair value of €50,000 at the inception of the lease.

How should the lease be accounted for in the financial statements for the year end 31 March 2015?

Solution

The lease of the machine is an operating lease because:

- ✓ the lease is for only four years of the ten-year life of the asset; and
- ✓ the present value of the minimum lease payments, if calculated, would be substantially less than the fair value of the asset.

Therefore the department will recognise lease rentals as an *expense* on the Statement of Financial Performance.

Rental payment made on 1 October covers the period *1 October 2014 – 30 September 2015.*

The accounting for this lease should therefore be:

	Debit	Credit
	€	€
Lease expense (€5,000/2)	2,500	
Prepayments	2,500	
Cash		5,000
Prepayment of 6 months from 1 April 2015 to 30 September 2015.		

Statement of Financial Performance (extract)	
	€
Lease expense	2,500

Statement of Financial Position (extract)	
	€
Current Assets	
Prepayments	2,500

2.4 Operating Leases - Example 2

On 1 April 2013, a Government Department leased a machine from a third party on a 3 year lease. The expected future economic life of the machine on 1 April 2013 was 6 years. If the machine breaks down, then under the terms of the lease, the third party would be required to repair the machine or provide a replacement. Third party agreed to allow the department to use the machine for the first six months of the lease without the payment of any rental as an incentive to sign the lease agreement. After this initial period, lease rentals of €240,000 were payable six-monthly in arrears, the first payment falling due on 31 March 2014.

How should the lease be accounted for in the financial statements for the year end 31 March 2014?

Solution

The lease of the machine is an operating lease because:

- ✓ the risks and rewards of ownership of the machine remain with the third party;
- ✓ the lease is for only three years of the six-year life; and
- ✓ the third party is responsible for breakdowns etc.

Therefore the department will recognise lease rentals as an *expense* on the Statement of Financial Performance.

The Lease Expense should be recognised on a straight-line basis.

The total lease rentals payable over the whole 3 year lease term are equivalent to €240,000 x 5 payments* = €1,200,000.
*(*over 3 years there should have been 6 payments, but the first period was free)*

The straight-line charge per period is €1,200,000 over 3 years = €400,000 (€1,200,000/3).

The difference between the straight-line charge for the period (€400,000) and the rent actually paid (€240,000), amounting to €160,000, will be shown as a *liability* in the Statement of Financial Position at 31 March 2014.

On 31st August 2014 and 31st March 2015, €240,000 x 2 = €480,000 will be paid respectively, therefore €80,000 (€480,000 less the lease expense of €400,000) of the liability of €160,000 will be paid within one year (classified as a current liability); the remaining €80,000 will be paid after more than one year (classified as a non-current liability).

	Debit	Credit
	€	€
Lease expense (straight-lined amount)	400,000	
Operating lease liability (€400,000 - €240,000)		160,000
Bank (actual payment)		240,000
Recognising the straight-lined amount and actual amount paid		

Statement of Financial Performance (extract)	
	€
Lease expense (straight-lined amount)	400,000

Statement of Financial Position (extract)	
	€
Current Liabilities	
Operating lease liability	80,000
Non-Current Liabilities	
Operating lease liability	80,000

E. Leases in the Financial Statements of Lessor

1. **Finance Lease**

1.1 Initial Recognition: At the commencement of the lease term, the lessor should recognise the *lease receivable* on the Statement of Financial Position. The amount of the *receivable* should be *equal* to *net investment in the lease*.

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

1.3 Gross investment in the lease is the aggregate of:
- The minimum lease payments receivable by the lessor under a finance lease; and
- Any unguaranteed residual value accruing to the lessor.

1.4 Therefore:

1.4.1. NET investment is the *capital* portion, and the

1.4.2. GROSS investment is the *capital* *plus* *unearned finance revenue*.

1.5 Unearned finance revenue is thus the difference between
- the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor and
- the present value of the above, at the interest rate implicit in the lease.

1.6 The accounting entry is as follows:

Debit	Lease Receivable
Credit	Cash

1.7 If the lessor incurs any *initial direct and incremental costs* in negotiating leases (e.g. commissions, legal fees), those must be recognised over the lease term and not expensed when incurred.

1.8 Example – calculating the Net Investment in a lease

A department leased medical equipment:
Lease term: 2 years
Inception of lease: 1 Jan 2014
Annual instalments in advance: €44,000
Residual value of asset as guaranteed by lessee: €11,000
Expected residual value at end of lease: €13,200
Interest rate implicit in the lease: 10%

Show the net investment in the lease at 1 January 2014 and 31 December 2014

Solution

Net investment in the lease at 1 January 2014:

		Gross Investment	Discount factor (10%)	Net Investment
		€		**€**
1.1.2014	Instalment	44,000	1	44,000
1.1.2015	Instalment	44,000	1/1.10	40,000
31.12.2015	Guaranteed residual value	11,000	1/1.21	9,091
	Minimum lease payments	**99,000**		**93,091** **Lessee liability**
31.12.2015	Unguaranteed residual value (€13,200 - €11,000)	2,200	1/1.21	1,818
		101,200		**94,909** **Lessor asset**

- PV of 2nd instalment is €40,000
- PV of guaranteed residual value is €9,091
- PV of unguaranteed residual value is €1,818
- Difference between the Gross and Net Investment is the unearned interest, amounting to €6,291.

<u>Unguaranteed residual value</u> is that portion of the residual value of the leased asset, the realization of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Net investment in the lease at 31 December 2014:		
		€
1.1.2014	Balance b/d	94,909
1.1.2014	Instalment in advance	(44,000)
		50,909
	Interest for 2014 @ 10%	5,091
31.12.2014	Balance c/d	**56,000**

1.9 <u>Subsequent Measurement:</u> The lessor should split minimum payments received into finance income and reduction of the lease receivable.

1.10 The accounting entry is as follows:

Debit	Cash
Credit	Finance Income (Interest)
Credit	Lease Receivable

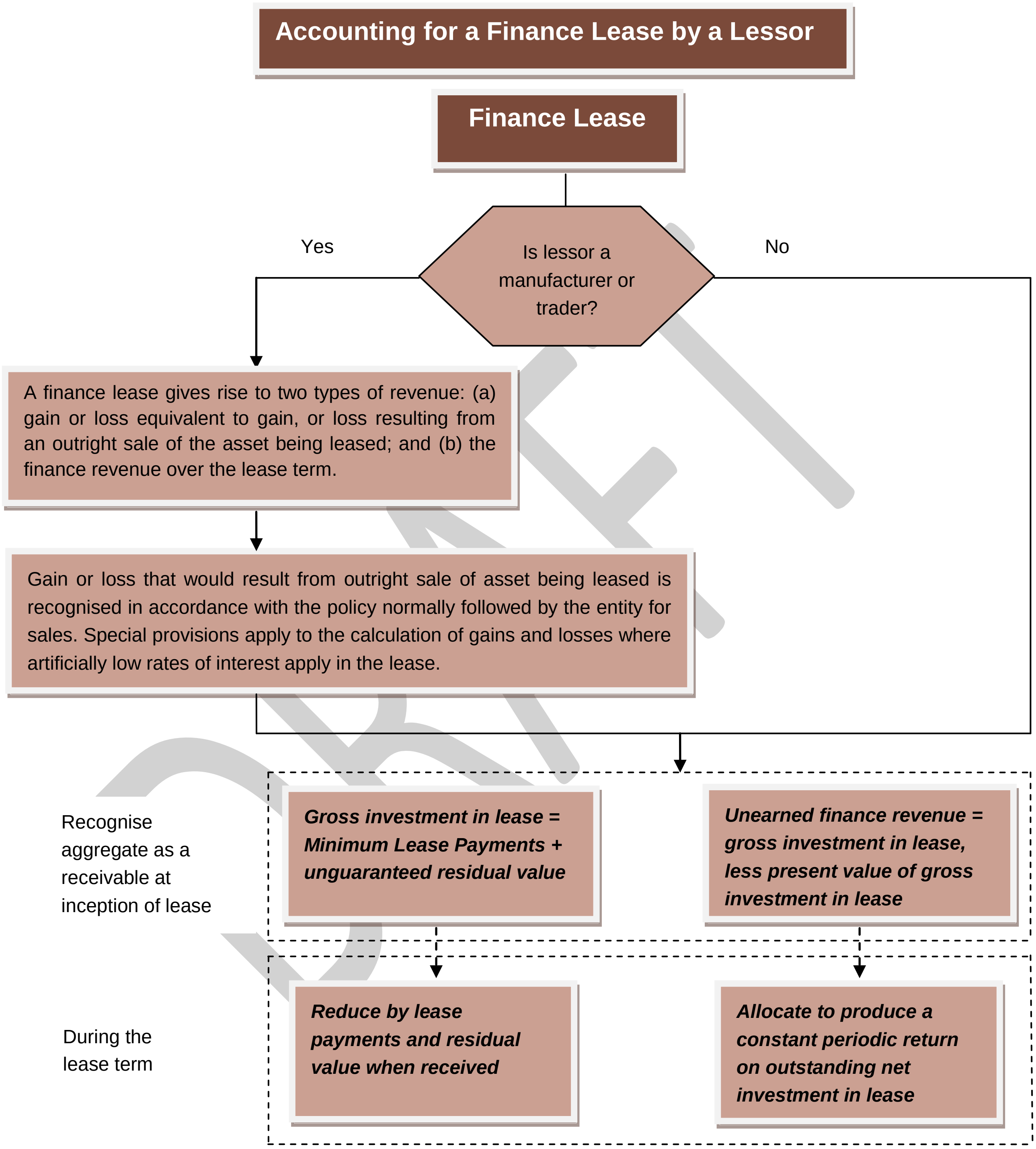
1.11 Finance income shall be recognised based on a pattern reflecting a *constant periodic rate of return* on the lessor's net investment outstanding in respect of the finance lease in each period.

1.12 In arriving at the constant periodic rate of return, a reasonable approximation may be made.

1.13 The lease payments (excluding costs for services) relating to the accounting period should be applied against the gross investment in the lease, so as to reduce both the principal and the unearned finance income.

1.14 The estimated unguaranteed residual values used to calculate the lessor's gross investment in a lease should be reviewed regularly. If there has been a reduction in the value, then the income allocation over the lease term must be revised. Any reduction in respect of amounts already accrued should be recognised immediately.

1.15 Accounting for a Finance Lease by a Lessor



1.16 Accounting for a Finance Lease by a Lessor - Example

A private hospital (lessee) entered into a lease agreement with Mater Dei Hospital (lessor) on 1 April 2013 to lease specialised equipment for a period of 3 years. The useful life of the equipment is 4 years. The yearly lease payment is €60,000 payable in arrears beginning 1 April 2014 and the rate implicit in the lease is 5%. In addition the private hospital has to pay a contingent rent based on 2% of its revenue.

Revenue for private hospital over the three years was as follows:

Year 1	€200,000
Year 2	€250,000
Year 3	€150,000

The carrying amount of the equipment in the records of Mater Dei Hospital (lessor) on 1 April 2014 was €170,000.

The fair value of the machine is €189,000.

Show the accounting treatment of the lease in the financial statements of the *lessor* to the year ended 1 April 2016.

Solution:

Step 1: Determine the Present Value of Minimum Lease Payments.

PV of minimum lease payments:

$$\text{PV of MLP} = pmt \text{ x} \frac{1}{(1+r)^n}$$

pmt = payment made each period
r = rate implicit in the lease
n = total number of payment periods

Year 1 = €60,000 $\text{x} \frac{1}{(1+0.05)^1}$ = €57,143

Year 2 = €60,000 $\text{x} \frac{1}{(1+0.05)^2}$ = €54,422

Year 3 =€60,000 $\text{x} \frac{1}{(1+0.05)^3}$ = €51,830

Step 2: Determine the amount at which the net investment would be recognised in the records of the lessor.

Note that the net investment is the present value of the minimum lease payments due plus any unguaranteed residual value accruing to the lessor.

∴ In this case, the amount to be recognised as net investment is €163,395.

Step 3: Draw up an amortization table to split the lease receipts between the interest (unearned finance income) and capital portions as follows:

Date	Payment	Interest*	Capital**	Balance
1 April 2013				€163,395
1 April 2014	€60,000	€8,170 (5% x €163,395)	€51,830 (€60,000 - €8,170)	€111,565
1 April 2015	€60,000	€5,578 (5% x €111,565)	€54,422 (€60,000 - €5,578)	€57,143
1 April 2016	€60,000	€2,857 (5% x €57,143)	€57,143 (€60,000 - €2,857)	-
Total	**€180,000**	**€16,605**	**€163,395**	

*Interest: total outstanding balance x rate implicit in the lease

** Capital: receipt less interest

Contingent rent is not added in the amortisation table. This should be recognised in the period when received, therefore it will not form part of the net investment receipts.

Note: If we take the same example above but assume that the lease payments were made on a *monthly* basis, the amortisation table will need to be drawn up on a *monthly* basis.

Step 4: Recognise the net investment and the gain/loss on derecognition of the machine.

Accounting entries in the books of the lessor will be as follows:

Year 1	**Debit**	**Credit**
	€	€
Gross investment in lease	180,000	
Unearned finance income		16,605
Loss on derecognition of asset*	6,605	
Equipment (Leased asset)		170,000
Recognising the lease payments receivable (i.e. net investment in lease) and derecognising the equipment leased.		

**Since the equipment is being leased, it is no longer recognised as an asset of the lessor but as an investment. The loss on derecognition reflects the net effect of recognising the gross investment in the lease (less unearned finance income) and derecognising the asset.*

The two amounts can also be netted off to reflect only the capital amount outstanding (net investment in the lease). The net effect of both methods is the same, as the gross investment in the lease and the unearned finance income are netted off for disclosure purposes.

The journey entries will be netted off as follows:

	Debit	**Credit**
Net investment in lease	€163,395	

Subsequent measurement - journal entries year 1 to year 3:

Year 1	**Debit**	**Credit**
	€	€
Bank (actual receipt)	64,000	
Gross Investment in lease		60,000
Unearned finance income	8,170	
Interest received		8,170
Lease revenue (contingent rent - €200,000 x 2%)		4,000
Receipt of first instalment and contingent rent		

Year 2	Debit	Credit
	€	€
Bank (actual receipt)	65,000	
Gross Investment in lease		60,000
Unearned finance income	5,578	
Interest received		5,578
Lease revenue (contingent rent - €250,000 x 2%)		5,000
Receipt of second instalment and contingent rent		

Year 3	Debit	Credit
	€	€
Bank (actual receipt)	63,000	
Gross Investment in lease		60,000
Unearned finance income	2,857	
Interest received		2,857
Lease revenue (contingent rent - €150,000 x 2%)		3,000
Receipt of third instalment and contingent rent		

2. **Manufacturer/trader lessors**

2.1 Manufacturers or traders can offer customers the choice of either buying or leasing an asset. There will be two types of income under such a lease:

2.1.1. Profit/loss equal to that from an outright sale (normal selling price less any discount)
2.1.2. Finance income over the lease term

2.2 Accounting treatment:

2.2.1. Recognise the selling profit/loss in income for the period as if it was an outright sale;
2.2.2. If interest rates are artificially low, restrict the selling profit to that which would apply had a commercial rate been applied;
2.2.3. Recognise costs incurred in connection with negotiating and arranging a lease as an expense when the selling profit is recognised (at the start of the lease term).

3. Operating Leases

3.1 In an operating lease the risks and rewards of ownership are NOT transferred from the lessor to the lessee. Thus, the lessor keeps recognizing the leased asset in the Statement of Financial Position as a non-current asset and depreciates the asset over its useful life.

3.2 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 guidelines for IPSAS 17, PP&E.

3.3 Lease income from operating leases, excluding charges for services such as insurance and maintenance, shall be recognised as an *income* on the Statement of Financial Performance on a straight-line basis over the lease term, unless another systematic basis is more appropriate.

> Note that any difference between the **actual lease amounts received** and the **straight-lined amounts** will be recognised as operating lease assets or liabilities on the Statement of Financial Position.

Operating lease asset	Operating lease liability
• **actual amount received < straight-lined amount**	• **actual amount received > straight-lined amount**

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

3.5 Operating Leases - example

On 1 January 2014 the Government Printing Press leased printing equipment to a small private printing press to print various booklets for a monthly rental of €10,000 for 6 months. The private printing press paid €60,000 on 1 January 2014. The cost of the equipment is €300,000 and it is being depreciated over 5 years.

The Government Printing Press (lessor) would record the following transactions in its books of accounts:

	Debit	Credit
	€	€
Bank	60,000	
Unearned lease rental revenue		60,000
Rental of €60,000 paid in advance		

The lessor should record the lease rental income equally over the life of the lease term despite the fact that that all the payment was received on 1 January 2014. Government Printing Press will record lease rental income of €10,000 per month for the six months as follows (€60,000/6mths):

	Debit	Credit
	€	€
Unearned lease rental revenue	10,000	
Lease rental revenue		10,000
Monthly lease rental income (straight –line basis)		

As a result since the actual lease amount received (€60,000) is greater than the straight-lined monthly amount received (€10,000), the difference will be recognised as an operating lease liability in the monthly Statement of Financial Position. Moreover lease revenue should be recorded in the monthly Statement of Financial Performance.

During the six months, the Government Printing Press should continue recording the equipment as PP&E and depreciate it accordingly.

	Debit	Credit
	€	€
Depreciation (€300,000/(5yrs x 12)	5,000	
Accumulated depreciation		5,000
Recognising monthly depreciation on the leased asset		

Statement of Financial Performance (extracts)	
	€
Month 1	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000
Month 2	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000
Month 3	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000
Month 4	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000
Month 5	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000
Month 6	
Lease rental revenue (income)	10,000
Depreciation of leased asset (expenditure)	5,000

Statement of Financial Position (extracts)	
	€
Month 1	
Non-current assets	
PP&E: Equipment (€300,000 - €5,000)	295,000
Current Liabilities	
Operating lease liability (€60,000 - €10,000)	50,000
Month 2	
Non-current assets	
PP&E: Equipment (€300,000 - €10,000)	290,000
Current Liabilities	
Operating lease liability (€60,000 - €20,000)	40,000
Month 3	
Non-current assets	
PP&E: Equipment (€300,000 - €15,000)	285,000
Current Liabilities	
Operating lease liability (€60,000 - €30,000)	30,000
Month 4	
Non-current assets	
PP&E: Equipment (€300,000 - €20,000)	280,000
Current Liabilities	
Operating lease liability (€60,000 - €40,000)	20,000
Month 5	
Non-current assets	
PP&E: Equipment (€300,000 - €25,000)	275,000
Current Liabilities	
Operating lease liability (€60,000 - €50,000)	10,000
Month 6	
Non-current assets	
PP&E: Equipment (€300,000 - €30,000)	270,000
Current Liabilities	
Operating lease liability (€60,000 - €60,000)	-

F. Lessee Accounting versus Lessor Accounting

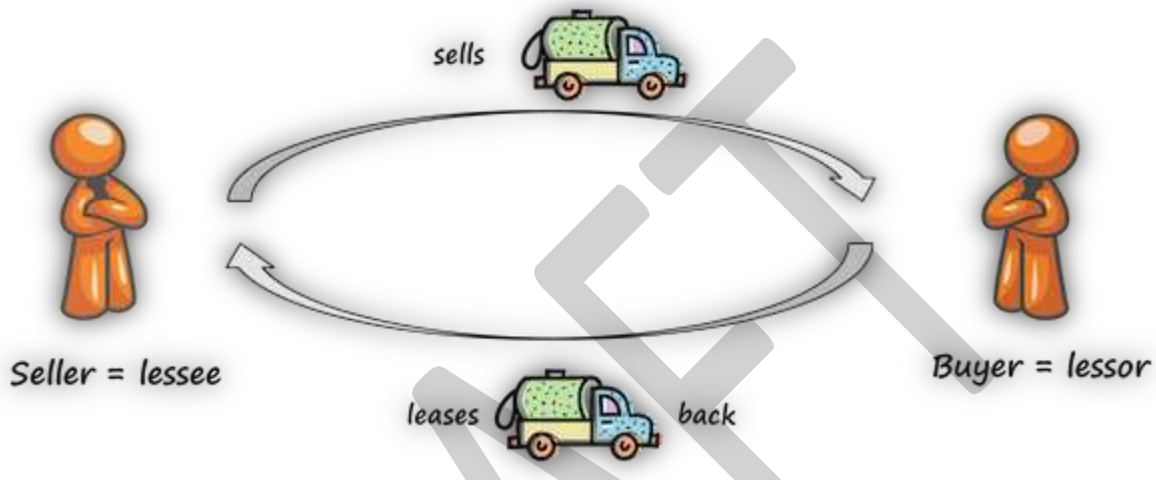
Finance Lease		
	Lessee Accounting	Lessor Accounting
Statement of Financial Position	Property, plant & equipment X Lease liability Present value of: • Minimum lease payments X	No property, plant and equipment Lease receivable (net investment in lease) Present value of: • Minimum Lease payments X • Unguaranteed residual value X X
Statement of Financial Performance	Depreciation X Finance cost X	No depreciation Finance income X

Operating Lease		
Statement of Financial Position	Lessee Accounting	Lessor Accounting
	No property, plant and equipment	Property, plant & equipment X
Statement of Financial Performance	No depreciation Rental expense (normally straight line over lease term) X	Depreciation X Rental income (normally straight line over lease term) X

G. Sale and Leaseback Transactions

1. Sale and Leaseback Transactions

> IPSAS 13: A ***sale and leaseback transaction*** involves the sale of an asset and the leasing back of the same asset.



1.1 The lease payment and sale price are normally interdependent because they are negotiated as part of the same package.

1.2 Accounting treatment of sale and leaseback transactions depends on the nature of the resulting lease.

2. Sale and Leaseback with Finance Lease

2.1 If an asset is sold and then finance-leased back, effectively this asset has not been sold as the risk and rewards have not been transferred. Therefore the entity simply wishes to raise finance by getting the sale proceeds now and repaying over the lease term whilst still using the asset. In this way, the entity has the opportunity to release capital invested in this asset for investment in other projects.

2.1.1 As the seller (who then becomes the lessee) has not transferred the risks and rewards of holding the asset, the seller cannot immediately recognise a profit on disposal.

2.1.2 The profit on disposal is deferred and subsequently amortised as income over the lease term.

3. Sale and Leaseback with an Operating Lease

3.1 If the leaseback is an operating lease, then a seller/lessee derecognises the asset and a buyer/lessor recognises the asset. Further accounting treatment depends on the sale price:

3.1.1 If the *sale price* is close to *asset's fair value*, then the profit or loss from sale should be recognised immediately.

3.1.2 If the *sale price* is *below asset's fair value*, then it is necessary to check the rental payments. If the future lease payments are below market price, then the loss from the sale of asset should be amortised over the period of use. If the future lease payments are close to market rentals, then the loss from the sale of asset should be recognised immediately.

3.1.3 If the *sale price* is *above fair value*, then the excess over fair value or "profit from sale" should be deferred and amortised over the period of use.

3.1.4 In addition, for an operating lease where the *fair value* of the asset at the time of the sale is *less than the carrying amount*, the loss (carrying value less fair value) should be recognised immediately.

3.2 The buyer or lessor should account for a sale and leaseback in the same way as other leases.

3.3 The disclosure requirements for both lessees and lessors apply equally to sale and leaseback transactions. Sale and leaseback transactions may be required to be separately disclosed in accordance with IPSAS 1 Presentation of Financial Statements.

Summary – Leaseback as an operating lease		
BV = book value; SP = sale proceeds; FV = fair value		
SP = FV	SP < FV	SP > FV
• Recognise any profit/loss immediately	• Recognise any profit/loss immediately unless the apparent loss is compensated by future rentals at below market price, in which case defer and amortise over period asset is expected to be used	• Defer excess over fair value and amortise over period asset is expected to be used. • In substance this excess is a loan which would be held at amortised cost. Consequently, the operating lease rentals would need to be split between the fair market rental and the repayment of the loan plus interest.
In all cases, if FV < BV, recognise the loss of BV – FV immediately.		

3.4 Sale and Leaseback Transactions (operating lease) – Example 1

1. Sale price above fair value		
		€
Book Value (BV)		100
Fair Value (FV)		120
Sale Price (SP)		135
Gain to be recognised (FV – BV)		20
Gain to be deferred (SP – FV)		15
2. Sale price below fair value		
	Asset A	**Asset B**
	€	**€**
Book Value (BV)	100	100
Fair Value (FV)	135	120
Sale Price (SP)	110	95
Gain to be recognised (SP – BV)	10	-
Apparent loss deferred if compensated by below market rentals (SP – BV)	-	(5)

3.5 Sale and Leaseback Transactions (operating lease) – Example 2

On 1 January 2014, Government Property Department held a building in its books with a net book value of €250,000 and a remaining useful life of 30 years.

On the same date, it entered into agreement to sell the building to a private company for €500,000, but to continue to occupy it for the next 5 years at an annual rental of €50,000 per annum payable in advance.

The market value of the building at the date of sale was approximately €450,000 and an ‘arm’s length’ rental would be approximately €40,000 per annum. Finance costs are 8% per annum.

Solution

The transaction provides the department with a cash injection which improves liquidity and cash flow. Given that the remaining useful life of the property is 30 years, but the leaseback is only for 5 years, this is considered to be an *operating leaseback*.

Consequently, the property should be derecognised and a profit on sale recognised.

However, the future rentals paid are above the market price as is the sale price of the property. This suggests that the excess sale proceeds above the property's fair value is in substance a loan rather than part of the sale proceeds, given that it is linked to the higher than market rental payments, and so it should be accounted for as a loan.

The rental payments above market price will be treated as loan payments paying off capital and accrued interest. Given that rental payments are made in advance, the first payment will be treated as paying back the loan rather than including any interest element.

The profit recognised on sale of the building should therefore be €200,000 (€450,000 fair value less €250,000 book value). The excess €50,000 will be shown in the statement of financial position as a loan payable as follows:

	€
Excess sale proceeds (€500,000 – €450,000)	50,000
First rental payment in excess of market value (€50,000 - €40,000)	(10,000)
	40,000
Interest accrued (8% x €40,000)	3,200
Balance as 31 December 2014	**43,200**

The market rental of €40,000 will be charged as an expense along with the €3,200 interest on the loan.

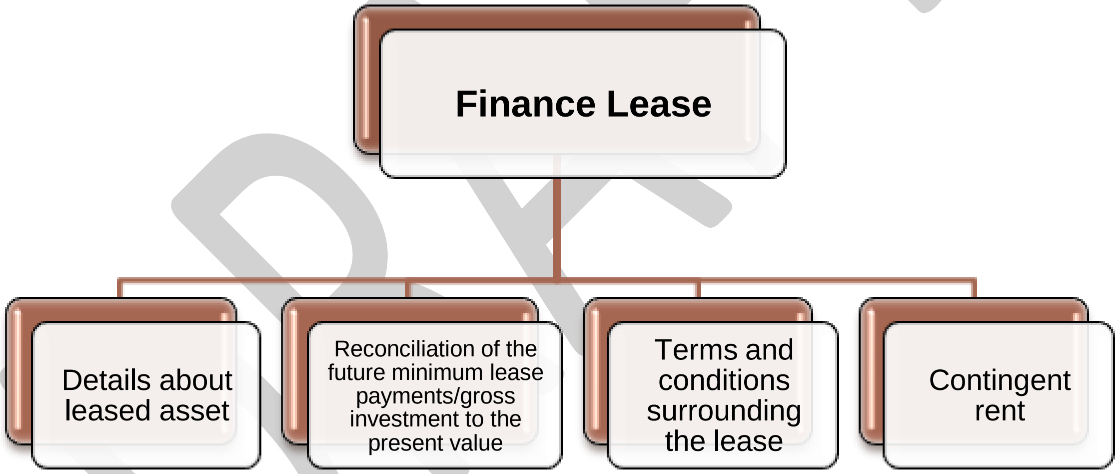
H. Disclosure of Leases

1. Disclosure requirements for lessees and lessors

1.1 Finance leases: lessees are required to present a reconciliation between the total of future minimum lease payments and their present value; lessors are required to present a reconciliation between the total gross investment in the lease, and the present value of minimum lease payments – in both cases according to the period when they are due:

- Not later than 1 year,
- Later than 1 year and not later than 5 years;
- Later than 5 years.

1.1.1 Disclosure that should be in both the lessee's and lessor's financial statements:



1.1.2 For a detailed description of the disclosure requirements, refer to the accounting standard IPSAS 13 Leases as follows:

1.1.2.1 section 40 Finance Leases (Lessees)
1.1.2.2 section 60 Finance Leases (Lessors)

1.1.3 Illustration of disclosure required:

Statement of Financial Position - Lessee [Extract]			
	Note	2014	2013
		€	€
Non-current Assets			
Property, plant and equipment	5	xx	xx
Current liabilities			
Finance lease obligation	8	xx	xx
Non-current liabilities			
Finance lease obligation	8	xx	xx

Statement of Financial Position - Lessor [Extract]			
	Note	2014	2013
		€	€
Current Assets			
Finance lease receivable	3	xx	xx
Non-current Assets			
Finance lease receivable	3	xx	xx

Statement of Financial Performance - Lessee [Extract]			
	Note	2014	2013
		€	€
Operating expenditure			
Finance charge		xx	xx
Depreciation	5	xx	xx

Statement of Financial Performance - Lessor [Extract]			
	Note	2014	2013
		€	€
Revenue			
Lease revenue: machinery		xxx	Xxx
Contractual		xx	Xx
Contingent rent		xx	Xx

Notes to the Financial Statements - Lessee [Extract]

5. Property, plant and equipment

5.1 Property, plant and equipment: net book values

	Land & Buildings	Plant & Machinery	Furniture, Fixtures & Equipment	IT Equipment	Vehicles	Total
Cost	€	€	€	€	€	€
At 1 January 2012	X	X	X	X	X	X
Additions	X	X	X	X	X	X
Disposals	X	X	X	X	X	X
Transfers/adjustments	X	X	X	X	X	X
At 31 December 2012	X	X	X	X	X	X
Additions	X	X	X	X	X	X
Disposals	X			X	X	X
Transfers/adjustments	X	X	X	X	X	X
At 31 December 2013	X	X	X	X	X	X
Depreciation & Impairment						
At 1 January 2012	X	X	X	X	X	X
Depreciation	X	X	X	X	X	X
Impairment	X	X	X	X	X	X
At 31 December 2012	X	X	X	X	X	X
Depreciation	X	X	X	X	X	X
Disposals	X	X	X	X	X	X
Impairment	X	X	X	X	X	X
Transfers/adjustment	X	X	X	X	X	X
At 31 December 2013	X	X	X	X	X	X
Net book values						
At 31 December 2013	X	X	X	X	X	X
At 31 December 2012	X	X	X	X	X	X

Notes to the Financial Statements - Lessee [Extract]

5.2 Property, plant and equipment: finance leases

	Furniture, Fixtures & Equipment	IT Equipment	Vehicles	Total
	€	€	€	€
Net book values				
At 31 December 2013	X	X	X	X
At 31 December 2012	X	X	X	X

Notes to the Financial Statements - Lessee [Extract]		
	2014	2013
	€	€
8. Finance lease obligation		
Total future minimum lease payments	xxx	xxx
- Within 1 year	xx	xx
- 2 to 5 years	xx	xx
- More than 5 years	xx	xx
Less: future finance charges	(xx)	(xx)
Present value of minimum lease payments	xxx	xxx
Present value of minimum lease payments due	xxx	xxx
- Within 1 year	xx	xx
- 2 to 5 years	xx	xx
- More than 5 years	xx	xx
Less: future finance charges	(xx)	(xx)
Present value of minimum lease payments	xxx	xxx
Non-current liability	xx	xx
Current liability	xx	xx
	xxx	xxx

Notes to the Financial Statements – Lessor [Extract]		
	2014	2013
	€	€
3. Finance lease receivable		
Gross investment in the lease due	xxx	xxx
- Within 1 year	xx	xx
- 2 to 5 years	xx	xx
- More than 5 years	-	-
Less: Unearned finance income	(xx)	(xx)
Present value of minimum lease payments	xxx	xxx
- Within 1 year	xx	xx
- 2 to 5 years	xx	xx
- More than 5 years	-	-
Non-current asset	xx	xx
Current asset	xx	xx
	xxx	xxx

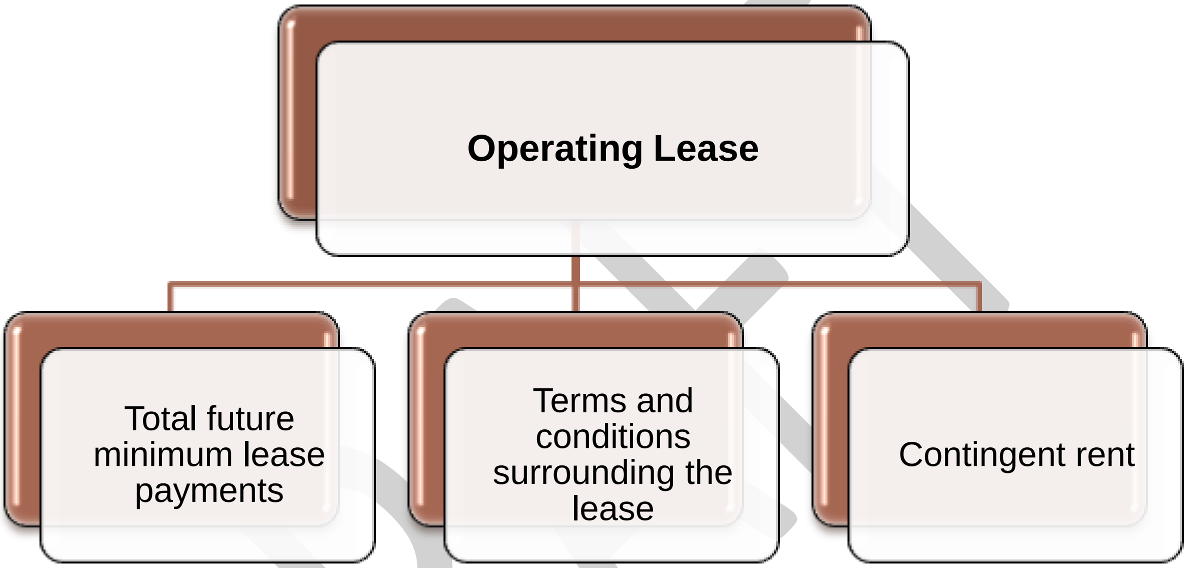
1.2 Operating leases: in this case of operating leases, both lessors and lessees are required to present the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

- Not later than 1 year,
- Later than 1 year and not later than 5 years;
- Later than 5 years.

1.2.1 For a detailed description of the disclosure requirements, refer to the accounting standard IPSAS 13 Leases as follows:

1.2.1.1 section 44 Operating Leases (Lessees)
1.2.1.2 section 69 Operating Leases (Lessors)

1.2.2 Disclosure that should be in both the lessee's and lessor's financial statements:



Note that the **future minimum lease payments or receipts** that have to be disclosed as commitments are the actual amounts that will be paid or received as per agreement, and not the straight-lined amounts recognised in the Statement of Financial Performance.

1.2.3 Illustration of disclosure required:

Notes to the Financial Statements [Extract]		
	2014	2013
	€	€
5. Expenses		
Rental expense: building	xxx	xxx
Contractual	xx	xx
Contingent rent	xx	xx
6. Operating lease commitments		
Operating lease as lessee	xxx	xxx
- Within 1 year	xx	xx
- 2 to 5 years	xx	xx
- More than 5 years	-	-

(**Note:** illustrative disclosure was not made for an operating lease as lessor. The disclosure is similar, except that revenue is recognised and the lessor still accounts for the asset in its records).

1.2.4 Illustration of disclosure required – example

Example – Significant accounting policies – Leases

Extract of the Notes to the Financial Statements

Entity as a lessee

Finance Leases

Finance leases are leases that transfer substantially the entire risks and benefits incidental to ownership of the leased item to the Entity. Assets held under a finance lease are capitalised at the commencement of the lease at the fair value of the leased property or, if lower, at the present value of the future minimum lease payments. The Entity also recognises the associated lease liability at the inception of the lease. The liability recognised is measured as the present value of the future minimum lease payments at initial recognition.

Subsequent to initial recognition, lease payments are apportioned between finance charges and reduction of the lease liability to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognised as finance costs in surplus or deficit.

An asset held under a finance lease is depreciated over the useful life of the asset. However, if there is no reasonable certainty that the Entity will obtain ownership of the asset by the end of the lease term, the asset is depreciated over the shorter of the estimated useful life of the asset and the lease term.

Operating Leases

Operating leases are leases that do not transfer substantially all the risks and benefits incidental to ownership of the leased item to the Entity. Operating lease payments are recognised as an operating expense in surplus or deficit on a straight-line basis over the lease term.

Example – Significant accounting policies – Leases

Extract of the Notes to the Financial Statements

Entity as a lessor

Finance Leases

The Entity recognises assets held under a finance lease as a receivable at an amount equal to the net investment in the lease. Under a finance lease substantially all the risks and benefits incidental to ownership are transferred by the lessor, therefore the lease payment receivable is treated by the Entity as a repayment of principal and finance income to reimburse and reward the lessor for its investment and services.

Glossary

''Accruals-based accounting'' Accruals-based accounting is a system of accounting based on the accrual principal, under which revenue is recognised (recorded) when earned, and expenses are recognised when incurred.

''Asset'' An asset is a resource presently controlled by the entity as a result of a past event and from which future economic benefits or service potential are expected to flow to the entity.

''Carrying amount (aka Net Book Value)'' The carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

''Cash-based accounting'' Cash-based accounting is an accounting method in which income is recorded when cash is received, and expenses are recorded when cash is paid out.

''Central Government Entities (CGEs)'' The term CGEs refers only to ministries and departments of the Government of Malta.

"Commencement of the lease" The term 'commencement of the lease' refers to 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 (i.e. the recognition of the assets, liabilities, revenue, or expenses resulting from the lease, as appropriate).

"Contingent rent" Contingent rent 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 (e.g., percentage of future sales, amount of future use, future price indices, future market rates of interest).

"Economic life" Economic life is either:

(a) The period over which an asset is expected to yield economic benefits or service potential to 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.

"Gross investment 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.

"Guaranteed residual value" 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.

"Inception of the lease" The term 'inception of the lease' refers to 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.

"Initial direct costs" Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or trader lessors. Examples of initial direct costs include amounts such as commissions, legal fees and relevant internal costs.

"Interest rate implicit in the lease" 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:

(a) The fair value of the leased asset, and
(b) Any initial direct costs of the lessor.

"International Public Sector Accounting Standards (IPSASs)" IPSASs are a set of accrual-based accounting standards issued by the IPSAS Board for use by public sector entities around the world in the preparation of financial statements.

"Lease term" 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.

"Lessee's incremental borrowing rate of interest" The lessee's incremental borrowing rate of interest is the rate 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.

"Minimum lease payments (MLPs)" MLPs are the payments over the lease term that the lessee is, or can be, required to make, excluding contingent rent, costs for services and, where appropriate, 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) An independent 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 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, then
- the minimum lease payments shall 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.

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

“Non-cancellable lease” 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.

“Unearned finance revenue” Unearned finance revenue is the difference between:

(a) The gross investment in the lease; and

(b) The net investment in the lease.

“Unguaranteed residual value” 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.

“Useful life” 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 or service potential embodied in the asset are expected to be consumed by the entity.