



INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF KENYA

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AccountAbility

IPSAS 13- LEASES



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PRESENTATION OUTLINE

- 1) Classification of operating and finance leases
- 2) Accounting for operating leases:
 - Lessee accounting
 - Lessor accounting
- 3) Accounting for finance leases:
 - Lessee accounting
 - Lessor accounting
- 4) Finance lease accounting and effective interest rate
- 5) Key disclosure requirements
- 6) Practical examples and implementation challenges

IPSAS 13- LEASES



LEASE

A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time.

IPSAS 13- LEASES



Introduction

IPSAS 13 – Leases was issued in July 2001 and revised in December 2006. The Standard is drawn primarily from International Accounting Standard (IAS) 17 (Revised 2003), Leases.

Objective & Scope

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for all leases other than: Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources; and Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights.

Summary

A lease is classified as a finance lease if it transfers substantially all risks and rewards incidental to ownership of an asset. The title may or may not be eventually transferred.

Examples:

- Lease covers substantially all of the asset's life and/or
- Present value of lease payments is substantially equal to the asset's fair value

All other leases are classified as operating lease. The land and building elements of a lease are considered separately for the purposes of lease classification

EXAMPLE

ANNUAL PAYMENT- KShs 25,000

LEASE PERIOD – 5YEARS

LIFE OF ASSET- 10 YEARS

RATE OF CONTRACT- 10%

PVF- 4.16987

Definition of a lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period

Finance
lease

Operating lease

Risks and rewards incident to ownership

• Risks

- Losses from idle capacity
- Technological obsolescence
- Changes in value due to changing economic conditions
- Etc.

• Rewards

- Expectation of service potential or profitable operation over the asset's economic life
- Gain from appreciation in value
- Realisation of a residual value
- Etc.

Finance leases —lessee's accounting:

- Recognise asset and liability at the lower of the present value of minimum lease payments and the fair value of the asset, determined at the inception of the lease. The discount rate applicable for calculating the present value shall be the interest rate implicit in the lease or the incremental borrowing rate.

- Depreciation policy —as for owned assets.

- Finance lease payment —apportioned between interest and reduction in outstanding liability

- Finance leases —lessor's accounting:

- Recogniseas a receivable in the statement of financial position at an amount equal to the net investment in the lease

- Recognise finance revenue based on a pattern reflecting a constant periodic rate of return on the lessor's net investment

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- Operating leases —lessee's accounting:
- Recognise lease payments as an expense in the statement of financial performance on a straight-line basis over the lease term, unless another systematic basis is representative of the time pattern of the user's benefit.
 - Operating leases —lessor's accounting
 - Assets held for operating leases shall be presented in the lessor's statement of financial position according to the nature of the asset.
 - Lease revenue shall be recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the benefits. •

Lessors of operating leases shall add initial direct costs incurred in negotiating and arranging an operating lease to the carrying amount of the leased asset and recognise them as an expense over the lease term on the same basis as the lease revenue.

- Accounting treatment of sale and leaseback transactions depends on whether these are essentially finance or operating leases.

Sale and Leaseback Transactions

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

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognized as revenue by a seller-lessee. Instead, it shall be deferred and amortized over the lease term.

Comparison with IAS 17

- Clarifies the applicability of the standards to accounting by public sector entities.
- Uses different terminology, in certain instances, from IAS 17. The most significant examples is the use of the term “statement of financial performance” in IPSAS 13. The equivalent term in IAS 17 is “income statement.”
- Does not use the term “income,” which in IAS 7 has a broader meaning than the term “revenue.”
- Has additional implementation guidance that illustrates the classification of a lease, the treatment of a finance lease by a lessee, the treatment of a finance lease by a lessor, and the calculation of the interest rate implicit in a finance lease.

Finance leases V Operating leases

Finance Lease

A lease is a finance lease if it **transfers** substantially all the risks and rewards incident to ownership

Operating Lease

A lease is an operating lease if it **does not transfer** substantially all the risks and rewards incident to ownership



Finance lease or Operating lease?

- If substantially all of the risks and rewards incident to ownership are transferred from the lessor to the lessee, it is a finance lease. The lessee should recognise finance leases as assets and liabilities in the balance sheet at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. The lessor should recognise assets held under a finance lease in its balance sheet and present it as a receivable at an amount equal to the net investment in the lease.

Finance lease or Operating lease?

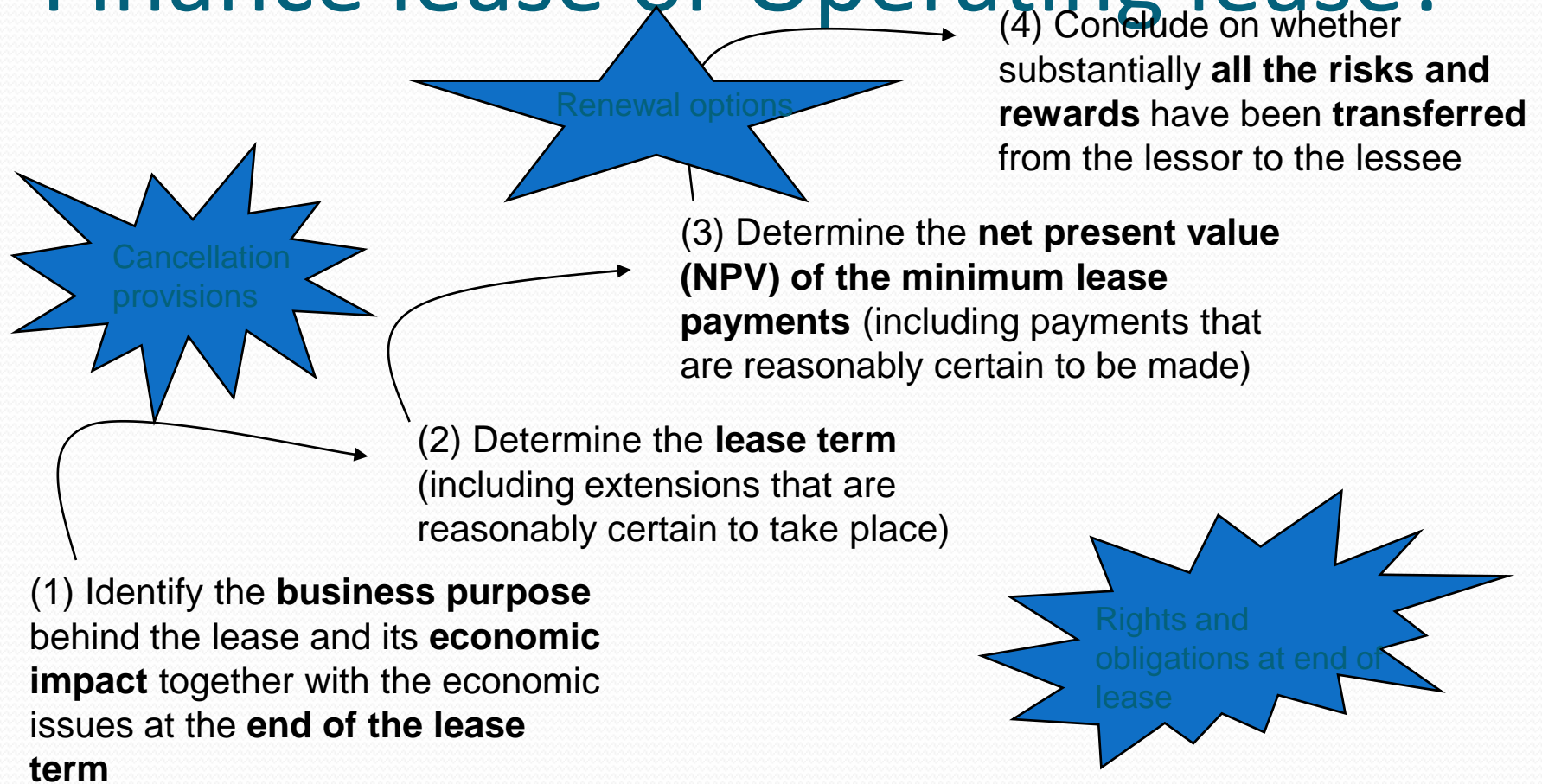
- If substantially all of the risks and rewards incident to ownership are not transferred from the lessor to the lessee, it is an operating lease: the financed assets remain on the lessor's balance sheet and the lease payments should be recognised in the income statement.

Finance lease or Operating lease?

- No mathematical thresholds are used to determine whether a lease should be classified as a finance or as an operating lease. An overall analysis of the transaction needs to be performed, at inception of the contract, to determine whether substantially all of the risks and rewards are transferred from the lessor to the lessee.



Finance lease or Operating lease?



Finance lease or Operating lease?

- Examples of situations which would normally lead to a lease being classified as a finance lease:
 - The lessor transfers ownership of the asset to the lessee at 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 the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised (“bargain” purchase option)

Finance lease or Operating lease?

- Examples of situations which would normally lead to a lease being classified as a finance lease (cont'd):
 - The lease term is for the major part of the economic life of the asset even if title is not transferred
 - The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made
 - The leased assets cannot be easily replaced
 - At the inception of the lease, the present value of the minimum lease payments (MLP) amounts to at least substantially all of the fair value of the leased asset .

Finance lease or Operating lease?

- Other indicators which individually or in combination could also lead to a lease being classified as a finance lease:
 - If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
 - The lessee bears gains/losses from changes in the fair value of the residual
 - The lessee has the ability to continue the lease for a secondary period at a rate which is substantially lower than market rate

Minimum lease payments


MLPs comprise the total payments by the lessee plus:

- payment required to exercise the lessee's bargain purchase option if it is reasonably certain that the lessee will exercise the option
- any amounts guaranteed by the lessee or by a party related to the lessee (e.g. the parent)
- any residual value guaranteed to the lessor by the lessee, by a party related to the lessee or by an independent third party

The minimum lease payments are discounted to their present value.

Implicit discount rate

The implicit discount rate is the rate that, at the inception of the lease, causes the present value of the sum of the minimum lease payments
+ plus the unguaranteed residual value
to equal the fair value of the leased asset.



The portion of the residual value on which the lessor is at risk – its realisation by the lessor is not assured

Operating lessee accounting

- Rental expense is recognised on a straight-line basis in the economic outturn account over the lease term
- Irrespective of the form or timing, the cost is recognised on a straight-line basis (e.g. free rent for a certain period at the beginning of the lease contract)
- Cut-off:
 - Accrue if service rendered but invoice not received at year-end
 - Defer if invoice received in advance of the service (to be rendered in the next accounting period)

Finance lessee accounting

– value at inception

Recognises the **asset** and the lease obligation on balance sheet

at the lower of the **present value of the minimum lease payments** and the fair value of the asset

Including initial direct costs incurred by the lessee in securing the lease (e.g. commission and legal fees)

Use interest rate **implicit** in the lease if this is practicable to determine; if not, use lessee's **incremental borrowing rate** – i.e. the rate at which the lessee would borrow to purchase a similar item

→ This corresponds to the **explicit** (facial) interest rate in simple, linear cases

Finance lessee accounting

– Subsequent measurement

- Depreciate assets with finite lives over their useful life
 - If it is **not** reasonably certain that ownership will be transferred to the lessee at the end of the lease term, the asset should be depreciated over the shorter of the lease term or its useful life
- Subsequent expenditures – refer to P,P & E
- Impairment – refer to P,P & E

Lease accounting summary

	Balance Sheet	Profit and Loss Account
Finance Lease - Lessee	Asset Lease Obligation Accumulated Depreciation Reduction in Lease Obligation	Finance Charge Depreciation Expense
Operating Lease - Lessee		Rental Expense

Key Disclosures – Finance leases (lessees)

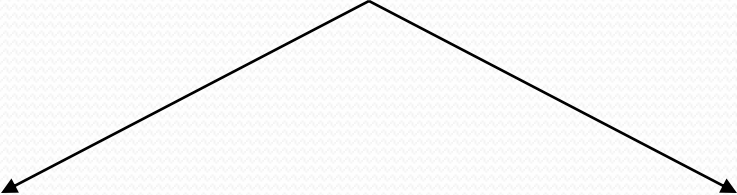
- For each class of asset, net carrying amount at the reporting date
- A reconciliation between the total of MLPs at the reporting date and their present value, including disclosure for each of the following periods: no later than 1 year; later than 1 year and not later than 5 years; and later than 5 years
- A general description of significant leasing arrangements

Key Disclosures – Operating leases (lessees)

- The total of future MLPs under non-cancellable operating leases for each of the following periods: no later than 1 year; later than 1 year and not later than 5 years; and later than 5 years
- A general description of the lessee's significant leasing arrangements

Leases Involving Land and Buildings

Analyse land and buildings individually



Land → indefinite
life → always
operating lease
(unless title
passes at the end
of the lease term)

Buildings →
apply IPSAS 13
to decide whether
finance or
operating lease

Classification of Leases of Land and Building

- Normally, the land element is classified as an operating lease unless the 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 the Standard.
- The minimum lease payments are allocated between the land and buildings elements in proportion to the relative fair values of the leasehold interests in the land and buildings elements of the lease.



THANK YOU

QUESTIONS AND ANSWERS