Lease Contract

- **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.**

❖ The obligations for maintenance may be assumed by the lessor or the lessee.

Classification of lease agreement

- A Finance Lease transfer substantially all of the benefits and risks of ownership.
- Transfer of benefits and risks of ownership can be assumed only if there is a high degree of performance to the transfer, that is, the lease is non-cancelable.
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications.
- Leases that do not substantially transfers benefits and risks of ownership are operating leases

Finance lease or Operating lease?

(1) Identify the **business purpose** behind the lease and its **economic impact** together with the economic issues at the **end of the lease term**

Cancellation provisions

(2) Determine the **lease term** (including extensions that are reasonably certain to take place)

Renewal options

(3) Determine the **net present value (NPV) of the minimum lease payments** (including payments that are reasonably certain to be made)

(4) Conclude on whether substantially **all the risks and rewards** have been **transferred** from the lessor to the lessee

Rights and obligations at end of lease

Transfer of benefits and risks

- Leases, transferring ownership at end of lease term
- Leases with bargain purchase options
- Leases with lease terms covering substantially most of the economic life of the leased property
- Leases where the present value of lease payments is equal or approximate to the fair market value.

Risk and reward

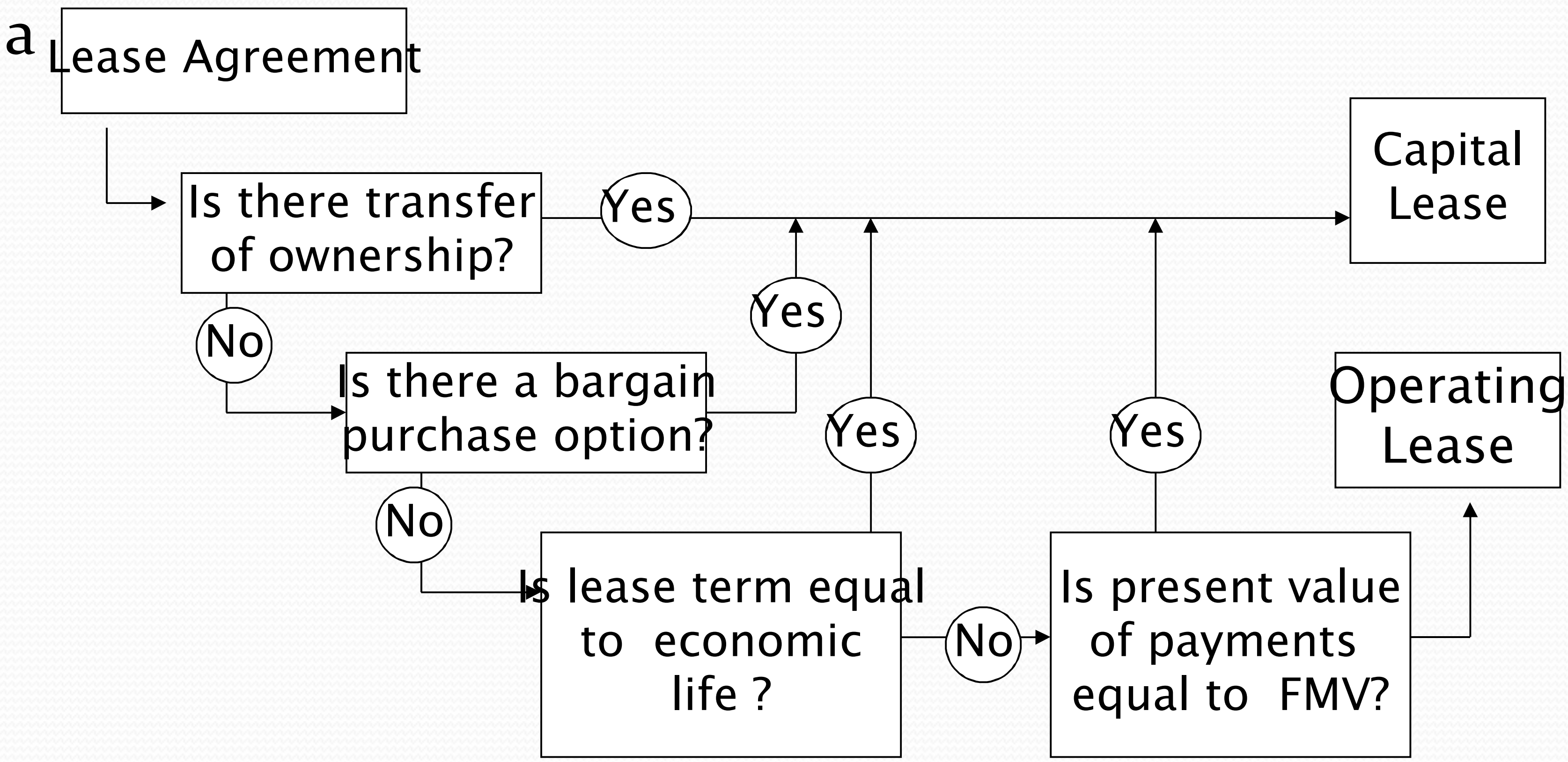
- Risks
  - Losses from idle capacity
  - Technological obsolescence
  - Changes in value due to changing economic conditions

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

Lease of land and building

- If lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately
- In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.
- Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property.
- It is possible for a lessee to classify a property interest held under an operating lease as an investment property.

Classification Decision



Accounting by lessee

- If the lease is a Finance (capital) lease: record an asset (leased equipment) and a liability (lease obligation) equal to the present value of the rental payments (contingent rents charged as expenses in the periods in which they are incurred.)
- If the lease is an operating lease: do not record asset or liability record rental expense as rental payments are made to lessor.
    - Operating lease rental which include expected inflation may not be expensed on straight line

Finance lease by lessee

- Recognise finance leases as assets and liabilities in the statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.
- The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used.
- Any initial direct costs of the lessee are added to the amount recognised as an asset.

Subsequent measurement

- **Minimum lease payments apportioned between the finance charge and the reduction of the outstanding liability.**
- **The finance charge allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.**
- **Contingent rents charged as expenses in the periods in which they are incurred.**

Finance lease obligation repayment schedule

Start of Period (ten 6-month periods)	Opening Obligation	Lease Payments in Advance (MLPs = 10 x €12,000)	In-Year Obligation	Finance charge at 4.3535%	Capital repayment	Closing Obligation
1/1/2001	99,804	(12,000)	87,804	3,823	8,177	91,627
1/7/2001	91,627	(12,000)	79,627	3,467	8,533	83,094
1/1/2002	83,094	(12,000)	71,094	3,095	8,905	74,189
1/7/2005	12,000	(12,000)	nil	nil	12,000	nil

- Fair value of asset: ksh 101,346
- Unguaranteed residual value: none
- Lease period: 6 years
- Annual lease payment ksh 20,000
- In addition an up-front one-off fee of ksh 3,000 is payable

➔MLPs = 3,000 + 6 * 20,000 = 123,000

Effective rate implicit

- PV of MLPs + PV of unguaranteed residual value must equal the FV, i.e:

- Sh 3,000 at a discount factor of 1
- 3,000 Plus sh 20,000 * 6 year annuity factor must equal 98,346
- Must equal Fair value 101,346

- 6 year annuity factor = 98,346 / 20,000 = 4.9173

- i = 6%

PV of MLPs = FV because there is no unguaranteed residual value (=> finance lease); had there been an unguaranteed residual value applying this implicit rate to the MLPs would have resulted in a PV lower than FV

Accounting by lessee

- Depreciate the asset over the shorter of the lease term and its useful life.
- The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned.

Operating leases by lessee

- Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Accounting by lessor

- Recognise assets held under a finance lease as a receivable at an amount equal to the **net investment in the lease.**
- **The net investment in a lease is the lessor's gross investment in the lease discounted at the interest rate implicit in the lease.**

- The 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.

- Effect of IFRS 16

- Interactive session

Accounting by lessor

- Initial direct costs are included in the initial measurement of the finance lease receivable
- Costs incurred by manufacturer or dealer lessor in connection with negotiating and arranging a lease are recognised as an expense when the selling profit is recognised

Manufacturer or dealer lessors

- Recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.
- If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.
- Costs incurred by manufacturer or dealer lessor in connection with negotiating and arranging a lease are recognised as an expense when the selling profit is recognised.

Subsequent measurement

- The recognition of finance income is based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.
- A lessor aims to allocate finance income over the lease term on a systematic and rational basis.
- Estimated unguaranteed residual values used in computing the lessor's gross investment in the lease should be reviewed regularly.

Lessor in operating lease

- present assets subject to operating leases depending on the nature of the asset.
- recognise lease income from operating leases in profit or loss on a straight-line unless
  - another systematic basis is representative or
  - the payments to the lessor are structured to increase in line with expected general inflation.

Accounting by lessor

- **Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.**
- **The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets.**

Lessor dealer or manufacturer

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

- Lessor financier recognise cash out flow at inception

Implicit rate of interest

- The lessee computes the present value of the lease payments using the lessee's incremental borrowing rate
- If the lessee knows the lessor's implicit interest rate and it is less than the lessee's incremental rate, then such implicit rate must be used.
- The lessor's implicit rate produces the following result:
  - present value of (minimum lease payments and unguaranteed residual value) = fair value of the asset to lessor

Minimum lease payments

- **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; or**
- **for a lessor, any residual value guaranteed to the lessor by the lessee or a party related to the lessee.**

Minimum Lease Payments

They include:

- ❖ Minimum rental payments (which may or may not be equal to the minimum lease payments)
- ❖ Guaranteed residual value end of the lease term (guaranteed the lessor by the lessee or a third party)
- ❖ Any penalty required of the lessee for failure to extend or renew the lease
- ❖ Any bargain purchase option given to lessee

Accounting by lessor

- ***Unguaranteed residual value is that portion of the residual value of the leased asset,*** **the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.**

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.**

- ***Net investment in the lease is the gross investment in the lease discounted at the*** **interest rate implicit in the lease.**
- ***Unearned finance income is the difference between*** **the gross investment in the lease, and the net investment 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 the minimum lease payments and the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.**

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 (eg percentage of future sales, amount of future use, future price indices, future market rates of interest).**

Lease agreements

- Disclosure
- Lessee in a finance lease
  - Carrying amount of asset
  - Total of future minimum lease payments categorised for amount due
    - Not later than a year
    - Later that a year but not more than five years
    - Later than five years
- Description of the lessee significant leasing arrangements eg renewals, contingent rent, subleases.

Lease agreements

- Lessee in operating lease
- Total of future minimum lease payment under non-cancellable categorised
    - Not later than one year
    - Later than one year but no more five years
    - Later than five years
- Amount recognised as expense
- Description of the lessee significant leasing arrangements

Lease agreements

- Lessor in a finance lease
- Reconciliation of gross investment in the lease and the present value of minimum lease payments categorised
- Unearned finance income
- Unguaranteed residual value
- Allowance for uncollectible minimum lease payments
- Contingent rents
- General description of the lessor significant leasing arrangements

Lease agreement

- Lessor in an operating lease
- Total of future minimum lease payment under non-cancellable categorised
    - Not later than one year
    - Later than one year but no more five years
    - Later than five years
- Total contingent rents recognised as income
- Description of the lessee significant leasing arrangements

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.

Sale and finance leaseback

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

Sale and operating leaseback

- If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately.
- If the sale price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.
- If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.