

Chapter 14

Leases: Lessor Accounting

Reference: IAS 17

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1. Introduction

The principles explained in the chapter covering leases in the books of the lessees are essentially the same as those in the books of the lessor. The chief principle is substance over form. This means that where risks and rewards:

- *are* transferred at the end of a lease, the agreement is really a sale agreement in which financing has been provided by the so-called lessor: a finance lease; or
- *are not* transferred at the end of the lease, the agreement is a true lease: an operating lease.

The lease classification is therefore the same for a lessor as for a lessee.

2. Definitions

The definitions that are relevant to accounting for leases in the books of lessees are the same as those for lessors. Those definitions that apply to lessees are included in the chapter dealing with the accounting treatment of leases in the books of the lessee. This chapter includes only the extra definitions that apply only to the accounting treatment of leases in the books of the lessor.

- The ***interest rate implicit in the lease*** is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.
- ***Minimum lease payments*** are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:
 - a) For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
 - b) For a lessor, any residual value guaranteed to the lessor by:
 - (i) The lessee;
 - (ii) A party related to the lessee; or
 - (iii) A third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
- ***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.
- ***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.
- ***Initial direct costs*** are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.
- ***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.
- ***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:
 - a) The gross investment in the lease; and
 - b) The net investment in the lease.

3. Finance leases (IAS 17.36 - .48)

3.1 Overview: recognition and measurement

Whereas a lessee *pays* instalments under a finance lease representing both the amount payable for the asset acquired and interest expense, a lessor *receives* instalments.

For lessors who are considered to be manufacturers or dealers, a sale is considered to have taken place when the lease is a finance lease. Therefore sales income and interest income would be recognised on such a lease. For other lessors, the income from the lease is simply recognised as interest income.

Measurement of all amounts is therefore affected by whether the lessor is considered to be a manufacturer or dealer or considered not to be a manufacturer or dealer.

The journal entries in the books of the lessor will therefore differ slightly depending on whether the lessor is a manufacturer or dealer or not. The journal entries relevant to each of these two categories of lessor (manufacturer/ dealer or non-manufacturer/ dealer) are covered in specific sections further on.

3.2 Disclosure (IAS 17.47)

Lessors involved with finance leases must disclose the following information (in addition to the disclosure requirements laid down in *IFRS 7: Financial Instruments: Disclosure*):

- a reconciliation between the gross investment in the lease and the present value of future minimum lease payments receivable at the end of the reporting period;
- an analysis of both the gross investment and the present value of future minimum lease payments receivable at the end of the reporting period into:
 - receivable within one year
 - receivable between one and five years
 - receivable later than five years;
- unearned finance income;
- unguaranteed residual values accruing to the benefit of the lessor;
- accumulated allowance for uncollectible minimum lease payments receivable;
- contingent rents recognised as income in the period;
- a general description of the lessor's material leasing arrangements.

The first three bullets listed above can be achieved by presenting a note such as the following:

Example Limited

Notes to the financial statements (extracts)

For the year ended 31 December 20X3

	20X3	20X2	20X1
	C	C	C
25. Finance lease debtor			
Gross investment in finance lease	xxx	xxx	xxx
Within 1 year	xxx	xxx	xxx
After 1 year but before 5 years	xxx	xxx	xxx
After 5 years	xxx	xxx	xxx
Unearned finance income	xxx	xxx	xxx
Present value of future minimum lease payments (capital):	xxx	xxx	xxx
Within 1 year	xxx	xxx	xxx
After 1 year but before 5 years	xxx	xxx	xxx
After 5 years	xxx	xxx	xxx

3.3 If the lessor is a manufacturer or dealer (IAS 17.38; and .44 - .46)

3.3.1 Recognition (IAS 17.36 - .38)

For lessors who are *manufacturers or dealers* offering finance leases (i.e. instead of a cash sale), the instalments received represent *two types of income*:

- sales income; and
- interest income.

3.3.2 Measurement (IAS 17.38 and .42 - .46)

If the lessor is a manufacturer or dealer:

- sales income:
is measured at the lower of (a) the fair value of the asset or (b) the present value of the minimum lease payments, computed using a market interest rate;
- interest income:
should be measured at (a) the *rate implicit* in the agreement, (or (b) the *market interest rate* if the present value of the minimum lease payments is less than the fair value of the asset sold), multiplied by the *cash sales price* of the asset sold;
- any costs incurred in securing or negotiating the lease:
are simply expensed at the time that the sales revenue is recognised.

3.3.3 Journals

Remember that if the lessor is a manufacturer or dealer, the finance lease is considered to be a sale. The basic journal entries will therefore be as follows:

Jnl 1.	Dr	Finance lease debtors: gross investment (instalments receivable)
	Cr	Finance lease debtors: unearned finance income
	Cr	Sales revenue
Jnl 2.	Dr	Cost of sales
	Cr	Inventory
Jnl 3.	Dr	Bank
	Cr	Finance lease debtors: gross investment (instalment received)
Jnl 4.	Dr	Finance lease debtors: unearned finance income
	Cr	Finance income (interest income earned)

Journal entry 1

At the commencement of the lease term, lessors shall record finance leases by recognising:

- an asset (finance lease debtor); and
- a corresponding income (sales income).

These items will be raised at amounts equal to the lower of the:

- fair value of the leased property; or
- the present value of the minimum lease payments.

The discount rate used to calculate the present value of the minimum lease payments is the market interest rate.

At the inception of the lease, the finance lease debtor (IAS 17 calls this the 'net investment in finance lease') will represent the amount that the debtor would have owed had he bought the leased asset for cash.

This debtors balance is separated into two accounts: a positive asset and a negative asset (much the same as an item of equipment is separated into cost and accumulated depreciation). The two accounts making up the finance lease debtor include the:

- gross portion: representing the total instalments that the debtor has agreed to pay
- less the unearned finance income portion, representing the interest that the debtor has not yet incurred, but will incur over the period of the lease.

The reason this account is split into these two accounts is for disclosure purposes. Notice that, on this first day of the transaction, only the sales income is owed to the lessor. This is because interest is recognised on a time basis and therefore no interest income could yet have been earned on the first day of the transaction.

Journal entry 2

Where the lessor is a manufacturer or dealer, *inventory* is sold in which case there is obviously a cost of sale that needs to be recognised too.

Journal entry 3

The lease payments received reduce the debtors account.

Journal entry 4

The debtors account is increased by the interest earned on the debtors balance during the period. The interest income is calculated by multiplying the balance owing by the debtor by the market interest rate.

Costs incurred by a manufacturer or dealer lessor in arranging a lease are not included in the definition of initial direct costs. They are therefore excluded from the debtors balance and are simply recognised as an expense when the sales and cost of sales are recognised.

Example 1: finance lease in the books of a manufacturer or dealer

Lemon Tree Limited is a dealer in machines, which it sells for cash or under a finance lease.

Lemon Tree Limited sold only one machine (which it purchased on 1 January 20X1 for C250 000), during 20X1. The machine was sold under a finance lease, but had a cash sales price of C320 000.

The terms of the lease are as follows:

- inception of lease: 1 January 20X1
- lease period: 5 years
- lease instalments: C100 000, annually in arrears, payable on 31 December of each year.

The market interest rate applicable is 16,9911%.

Required:

Prepare the journal entries and the disclosure for each of the years ended 31 December 20X1 to 20X5 in Lemon Tree Limited's books (the books of the lessor). Ignore tax

Solution to example 1: finance lease in books of a manufacturer or dealer

W1: Analysis of total amount receivable		C
Total future lease payments	100 000 x 5 years	500 000
Guaranteed residual value	Not applicable in this example	0
Gross investment		500 000
Selling price (net investment)	Given	320 000
Gross profit	320 000 – 250 000	70 000
Cost of asset	Given	250 000
Finance income	500 000 – 320 000	180 000

W2: Finance income measured using the effective interest rate method				
Date	Instalment	Receipt in lieu of:		Debtors balance
		Interest	Capital	
1 Jan X1				320 000
31 Dec X1	100 000	54 372	45 628	274 372
31 Dec X2	100 000	46 618	53 382	220 990
31 Dec X3	100 000	37 549	62 451	158 539
31 Dec X4	100 000	26 938	73 062	85 477
31 Dec X5	100 000	14 523	85 477	0
	<u>500 000</u>	<u>180 000</u>	<u>320 000</u>	

(a) (b) (c) (d)

- (a) *Gross investment in finance lease: The total of this column represents the gross investment in the lease (the total amounts receivable from the lessee).*
- (b) *Unearned finance income: The total of this column represents the unearned finance income at the start of the lease and shows how this income is earned in each year.*
- (c) *The total of this column represents the sales price owed by the lessee at the start of the lease and shows how this capital sum is repaid by the lessee over the 5 years.*
- (d) *Net investment in finance lease: This column represents the actual balance owing by the lessee. This balance represents the present value of the future minimum lease payments (this balance equals the net investment in the lease, if the interest income earned is all received).*

1/1/20X1	Debit	Credit
Inventory	250 000	
Bank		250 000
<i>Purchase of inventory</i>		
Cost of sale	250 000	
Inventory		250 000
<i>Cost of machine sold under finance lease</i>		
Finance lease debtors – gross investment	500 000	
Finance lease debtors – unearned finance income		180 000
Sale		320 000
<i>Finance lease entered into, cash sales price of C320 000 and 5 years of arrear instalments of C100 000 each</i>		
31/12/20X1		
Bank	100 000	
Finance lease debtors – gross investment		100 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	54 372	
Finance income		54 372
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X2		
Bank	100 000	
Finance lease debtors – gross investment		100 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	46 618	
Finance income		46 618
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		

	Debit	Credit
31/12/20X3		
Bank	100 000	
Finance lease debtors – gross investment		100 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	37 549	
Finance income		37 549
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X4		
Bank	100 000	
Finance lease debtors – gross investment		100 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	26 938	
Finance income		26 938
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		
31/12/20X5		
Bank	100 000	
Finance lease debtors – gross investment		100 000
<i>Instalment received under finance lease</i>		
Finance lease debtors – unearned finance income	14 523	
Finance income		14 523
<i>Interest income earned at 16.9911%, (effective interest rate table: W2)</i>		

Lemon Tree Limited
Statement of financial position
As at 31 December 20X5

		20X5	20X4	20X3	20X2	20X1
<i>Non-current assets</i>	<i>Note</i>	C	C	C	C	C
Lease debtors	25	0	0	85 477	158 539	220 990
<i>Current assets</i>						
Lease debtors	25	0	85 477	73 062	62 451	53 382

Lemon Tree Limited
Notes to the financial statements
For the year ended 31 December 20X5

		20X5	20X4	20X3	20X2	20X1
25. Finance lease debtor		C	C	C	C	C
Gross investment in finance lease		0	100 000	200 000	300 000	400 000
• Within 1 year	W2: (a)	0	100 000	100 000	100 000	100 000
• After 1 year but before 5 years	W2: (a)	0	0	100 000	200 000	300 000
• After 5 years	W2: (a)	0	0	0	0	0
Unearned finance income	W2: (b)	(0)	(14 523)	(41 461)	(79 010)	(125 628)
		(W5)	(W4)	(W3)	(W2)	(W1)
Present value of future minimum lease payments (capital):		0	85 477	158 539	220 990	274 372
Within 1 year	W2: (c)	0	85 477	73 062	62 451	53 382
After 1 year but before 5 years	W2: (c)	0	0	85 477	158 539	220 990
After 5 years	W2: (c)	0	0	0	0	0

(W1) 180 000 – 54 372 (W2) 125 628 – 46 618 (W3) 79 010 – 37 549

(W4) 41 461 – 26 938 (W5) 14 523 – 14 523

3.4 If the lessor is not a manufacturer or a dealer (IAS 17.36 - .41A)

3.4.1 Recognition (IAS 17.36 - .38)

For lessors who are *neither manufacturers nor dealers*, the instalments received represent:

- the cost of the asset disposed of (i.e. finance leased); and
- finance income.

Therefore, for lessors who are neither manufacturers nor dealers, only *one type of income* is recognised, being interest income.

3.4.2 Measurement (IAS 17.36 - .41A)

If the lessor is neither a manufacturer nor a dealer:

- interest income:
should be measured at the *rate implicit* in the agreement multiplied by the *cost of the asset* disposed of under the finance lease;
- any costs incurred in securing or negotiating the lease (initial direct costs):
are included in the calculation of the implicit interest rate (thus automatically reducing the interest income recognised over the period of the lease).

3.4.3 Journals

If the lessor is not a manufacturer or dealer, the basic journal entries will be as follows:

Jnl 1.	Dr	Finance lease debtors: gross investment (instalments receivable)
	Cr	Finance lease debtors: unearned finance income
	Cr	Asset disposed of under the finance lease (cost or carrying amount)
Jnl 2.	Dr	Bank
	Cr	Finance lease debtors: gross investment (instalment received)
Jnl 3.	Dr	Finance lease debtors: unearned finance income
	Cr	Finance income (finance income earned)

Journal entry 1

At the commencement of the lease term, lessors shall record finance leases by recognising an asset (finance lease debtor) and a corresponding asset disposal. These items will be raised at the present value of the net investment in the lease, being defined as:

- the minimum lease payments owing to the lessor; plus
- any unguaranteed residual that may accrue to the lessor.

The discount rate used to calculate the present value of the minimum lease payments is the interest rate implicit in the lease.

At the inception of the lease, the finance lease debtor (or otherwise called ‘net investment in finance lease’) will represent the capital portion owing by the debtor. This is separated into two accounts: a positive asset and a negative asset (much the same as an item of equipment is separated into cost and accumulated depreciation). The two accounts making up the net investment include the:

- gross investment: representing the total instalments that the debtor has agreed to pay
- less the unearned finance income portion, representing the interest that the debtor has not yet incurred, but will incur over the period of the lease.

The reason this account is split into these two accounts is purely for disclosure purposes. Notice that the lessor is not owed any interest income on the first day of the transaction.

Journal entry 2

The lease payments received reduce the debtors account.

Journal entry 3

The debtors account is increased by the interest incurred by the debtor on the balance he owed to the lessor during the period. The interest income is calculated by multiplying the balance owing by the debtor by the appropriate interest rate.

Costs incurred by a lessor in arranging a lease (e.g. legal costs) where the lessor is neither a manufacturer nor a dealer are included in the definition of initial direct costs. They are therefore included in the calculation of the implicit interest rate and thus automatically reduce both the debtors balance and the income recognised over the period. There is therefore no need to add these costs separately.

Example 2: finance lease in the books of a lessor who is not a manufacturer or dealer

Orange Tree Limited is neither a dealer nor a manufacturer. Orange Tree Limited entered into an agreement under which Orange Tree Limited leased a machine to Beanstalk Limited.

Orange Tree Limited purchased this machine on 1 January 20X1 at a cost of C210 000. The lease is a finance lease, the terms of which are as follows:

The terms of the lease are as follows:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments: C90 000, annually in arrears, payable on 31 December of each year
- guaranteed residual value: C10 000, payable on 31 December 20X3.

The interest rate implicit in the agreement is 15.5819%.

Required:

Prepare the journal entries and disclosure for each of the years ended 31 December 20X1 to 20X3 in Orange Tree Limited's books (the books of the lessor).

Ignore tax

Solution to example 2: finance lease in books of a lessor who is not a manufacturer or dealer

W1: Analysis of total amount receivable		C
Total future lease payments	<i>90 000 x 3 years</i>	270 000
Guaranteed residual value	<i>Given</i>	10 000
Gross investment		280 000
Cost of asset	<i>Given</i>	210 000
Finance income	<i>280 000 – 210 000</i>	70 000

W2: Finance income measured using the effective interest rate method

Date	Instalment	Receipt in lieu of:		Debtors balance
		Interest	Capital	
1 Jan X1				210 000
31 Dec X1	90 000	32 722	57 278	152 722
31 Dec X2	90 000	23 797	66 203	86 519
31 Dec X3	100 000	13 481	86 519	0
	<u>280 000</u>	<u>70 000</u>	<u>210 000</u>	
	(a)	(b)	(c)	(d)

- (a) *Gross Investment in Finance Lease: the total of this column represents the gross investment in the lease (the total amounts receivable from the lessee)*
- (b) *Unearned Finance Income: the total of this column represents the unearned finance income at the start of the lease and shows how this income is then earned each year*
- (c) *The total of this column represents the sales price owed by the lessee at the start of the lease and shows how this capital sum is repaid by the lessee*
- (d) *Net Investment in Finance Lease: this column represents the actual balance owing by the lessee. This balance represents the present value of the future minimum lease payments (this balance equals the net investment in the lease, if the interest income earned is all received).*

Journals		Debit	Credit
1/1/20X1			
Machine	<i>Given</i>	210 000	
Bank			210 000
<i>Purchase of machine</i>			
<hr/>			
Finance lease debtors – gross investment	<i>W2 (a)</i>	280 000	
Finance lease debtors – unearned finance income	<i>W2 (b)</i>		70 000
Machine	<i>W3 (c)</i>		210 000
<i>Finance lease entered into over machine costing C210 000; total receivable: C280 000 (90 000 x 3 years + 10 000 residual value)</i>			
<hr/>			
31/12/20X1			
Bank		90 000	
Finance lease debtors – gross investment			90 000
<i>Finance lease instalment received</i>			
<hr/>			
Finance lease debtors – unearned finance income		32 722	
Finance income			32 722
<i>Interest income earned, (effective interest table, W2)</i>			
<hr/>			
31/12/20X2			
Bank		90 000	
Finance lease debtors – gross investment			90 000
<i>Finance lease instalment received</i>			
<hr/>			
Finance lease debtors – unearned finance income		23 797	
Finance income			23 797
<i>Interest income earned, (effective interest table, W2)</i>			
<hr/>			
31/12/20X3			
Bank	<i>90 000 + 10 000</i>	100 000	
Finance lease debtors – gross investment			100 000
<i>Finance lease instalment received and guaranteed residual</i>			
<hr/>			
Finance lease debtors – unearned finance income		13 481	
Finance income			13 481
<i>Interest income earned, (effective interest table, W2)</i>			
<hr/>			

Orange Tree Limited
Statement of financial position as at 31 December
20X3

	Notes	20X3	20X2	20X1
		C	C	C
<i>Non-current assets</i>				
Finance lease debtors	16	0	0	86 519
<i>Current assets</i>				
Finance lease debtors	16	0	86 519	66 203

Orange Tree Limited
Notes to the financial statements
For the year ended 31 December 20X3

		20X3	20X2	20X1
		C	C	C
16. Finance lease debtor				
Gross investment in finance lease		0	100 000	190 000
• Within 1 year	W2: (a)	0	100 000	90 000
• After 1 year but before 5 years	W2: (a)	0	0	100 000
• After 5 years	W2: (a)	0	0	0
Unearned finance income	W2: (b)	(0) (3)	(13 481) (2)	(37 278) (1)
Present value of future minimum lease payments		0	86 519	152 722
• Within 1 year	W2: (c)	0	86 519	66 203
• After 1 year but before 5 years	W2: (c)	0	0	86 519
• After 5 years	W2: (c)	0	0	0
(1) 70 000 – 32 722	(2) 37 278 – 23 797	(3) 13 481 – 13 481		

3.5 Instalments receivable in advance instead of in arrears

Instalments may be receivable in *advance* rather than in *arrears*. This needs to be taken into consideration when *calculating* the interest income using our effective interest rate table. Obviously the very first instalment will reduce the capital balance owing (i.e. it will only reduce the capital balance owing by the lessee and will not include a repayment of interest).

If the instalments are payable at the end of a period (arrears), the balance owing by the debtor at the end of that period (i.e. the net investment in finance lease) will simply be the portion of the original capital sum that he still owes to the lessor (i.e. the balance of the cash sum that he would have paid had he bought the asset instead of leased it under a finance lease): the debtor's balance will not include any interest.

If, however, the instalments are receivable during a period (advance), the balance owing by the debtor at the end of the period will include not only the remaining capital sum still owing by the debtor (present value of future minimum lease payments) but also the interest owing between the date of the last instalment made and the end of the period.

Depending on whether the instalments are payable in advance or in arrears will also affect the *disclosure* of the finance lease debtors in the notes to the financial statements, since the gross investment in the finance lease must be reconciled to the present value of the future minimum lease payments (capital outstanding) – which is now no longer equal to the balance on the finance lease debtors account (net investment in the finance lease).

Example 3: finance lease instalments receivable in advance

Pear Tree Limited is neither a dealer nor a manufacturer. Pear Tree Limited entered into an agreement in which Pear Tree leased a machine to Giant Limited (cost C210 000). The lease is a finance lease, the terms of which are as follows:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments: C80 000, annually in advance, payable on 1 January of each year
- guaranteed residual value: C10 000, payable on 31 December 20X3;
- interest rate implicit in the agreement: 18.7927%.

Required:

Prepare the journal entries and disclosure for each of the years ended 31 December 20X1 to 20X3 in Pear Tree Limited's books (the books of the lessor). Ignore tax

Solution to example 3: finance lease instalments receivable in advance

W1: Analysis of total amount receivable		C
Total future lease payments	$80\,000 \times 3 \text{ years}$	240 000
Guaranteed residual value	<i>Given</i>	10 000
Gross investment		250 000
Cost of asset	<i>Given</i>	210 000
Finance income	$250\,000 - 210\,000$	40 000

W2: Finance income using effective interest rate method

Date	Instalment	Receipt in lieu of:		Capital	Debtors
	A	Interest	Capital	Balance	Balance
		B	C	210 000 – C	210 000 – A + B
01 January X1				210 000	210 000
01 January X1	80 000	0	80 000	130 000	130 000
31 December 20X1		24 431		130 000	154 431
01 January X2	80 000		55 569	74 431	74 431
31 December 20X2		13 988		74 431	88 419
01 January X3	80 000		66 012	8 419	8 419
31 December 20X3		1 581		8 419	10 000
31 December 20X3	10 000		8 419	0	0
	250 000	40 000	210 000		
	(a)	(b)	(c)	(d)	(e)

(a) *Gross investment in finance lease: The total of this column represents the gross investment in the lease (the total amounts receivable from the lessee)*

(b) *Unearned finance income: The total of this column represents the unearned finance income at the start of the lease and shows how this income is then earned each year*

(c) *The total of this column represents the selling price owed by the lessee at the start of the lease and shows how this capital sum is repaid by the lessee*

(d) *Present value of minimum lease payments (capital balance): This column represents the capital balance receivable from the lessee.*

(e) *Net investment in finance lease: This column represents the total balance receivable from the lessee. It includes both the capital owing and the interest owing for the year, which in this example, will be paid as part of the next instalment. The net investment is no longer equal to the present value of future minimum payments (capital sum receivable) since the net investment includes interest income that is receivable.*

Journals	Debit	Credit
1/1/20X1		
Machine	210 000	
Bank		210 000
<i>Purchase of machine</i>		
Finance lease debtors – gross investment	250 000	
Finance lease debtors – unearned finance income		40 000
Machine		210 000
<i>Finance lease entered into over machine costing C210 000; total receivable: C250 000 (80 000 x 3 years + 10 000 residual value)</i>		
Bank	80 000	
Finance lease debtors – gross investment		80 000
<i>Finance lease instalment received</i>		

	Debit	Credit
31/12/20X1		
Finance lease debtors – unearned finance income	24 431	
Finance income		24 431
<i>Interest income earned, (effective interest table, W2)</i>		
1/1/20X2		
Bank	80 000	
Finance lease debtors – gross investment		80 000
<i>Finance lease instalment received</i>		
31/12/20X2		
Finance lease debtors – unearned finance income	13 988	
Finance income		13 988
<i>Interest income earned, (effective interest table, W2)</i>		
1/1/20X3		
Bank	80 000	
Finance lease debtors – gross investment		80 000
<i>Finance lease instalment received</i>		
31/12/20X3		
Finance lease debtors – unearned finance income	1 581	
Finance income		1 581
<i>Interest income earned, (effective interest table, W2)</i>		
Bank	10 000	
Finance lease debtors – gross investment		10 000
<i>Finance lease instalment received</i>		

Pear Tree Limited**Notes to the financial statements****For the year ended 31 December 20X3**

	20X3	20X2	20X1
	C	C	C
7. Finance lease debtors			
Gross investment in finance lease	0	90 000	170 000
• Within 1 year	0	90 000	80 000
• After 1 year but before 5 years	0	0	90 000 (1)
• After 5 years	0	0	0
Unearned finance income	0 (4)	(1 581) (3)	(15 569)(2)
Net investment in finance lease (debtors balance)	0	88 419	154 431

Represented by:

Finance income earned but receivable	0	13 988	24 431
Present value of future minimum payments (i.e. capital)	0	74 431	130 000
• Within 1 year	0	74 431 (5)	55 569
• After 1 year but before 5 years	0	0	74 431 (5)
• After 5 years	0	0	0

(1) W2 (a): 80 000 + 10 000

(2) W2 (b): 40 000 – 24 431

(3) W2 (b): 15 569 – 13 988

(4) W2 (b): 1 581 – 1 581

(5) W2 (c): 66 012 + 8 419

Pear Tree Limited
Statement of financial position
As at 31 December 20X3

		20X3	20X2	20X1
		C	C	C
<i>Non-current assets</i>				
Finance lease debtors: capital receivable	Notes 7	0	0	74 431
<i>Current assets</i>				
Finance lease debtors: capital receivable	7	0	74 431	55 569
Finance lease debtors: interest receivable	7		13 988	24 431

3.6 Instalments receivable during the year

Instalments may be receivable during the year rather than on either the first or last day of the year. The best way to approach this is to, when drawing up the effective interest rate table, plot all the payments on the dates on which they fall due. The interest that belongs to the year on which you are reporting is then simply apportioned in a separate calculation.

Example 4: finance lease instalments receivable during the period

Avocado Tree Limited is a dealer in machines.

Avocado Tree Limited entered into an agreement under which Avocado Tree Limited leased a machine to Giant Limited.

This machine was purchased by Avocado Tree Limited on 1 July 20X1 at a cost of C100 000.

The cash sales price of this machine is C210 000.

The lease is a finance lease, the terms of which are as follows:

- inception of lease: 1 July 20X1
- lease period: 5 years
- lease instalments: C60 000, annually in advance, payable on 1 July of each year
- interest rate implicit in the agreement: 21.8623%.

Required:

Prepare the journal entries and disclosure for each of the years ended 31 December 20X1 to 20X5 in Avocado Tree Limited's books (the books of the lessor).

Ignore tax

Solution to example 4: finance lease instalments receivable during the period

W1: Analysis of total amount receivable		C
Total future lease payments	$60\,000 \times 5 \text{ years}$	300 000
Guaranteed residual value	<i>Not applicable in this example</i>	0
Gross investment		300 000
Selling price (net investment)	<i>Given</i>	210 000
Gross profit	$210\,000 - 100\,000$	110 000
Cost of asset	<i>Given</i>	100 000
Finance income	$300\,000 - 210\,000$	90 000

W2: Finance income using effective interest rate method					
Date	Instalment	Receipt in lieu of:		Capital Balance	Debtors Balance
	A	Interest B	Capital C	210 000 – C	210 000 – A + B
1 July 20X1					210 000
1 July 20X1	60 000	0	60 000	150 000	150 000
1 July 20X2	60 000	32 793	27 207	122 793	122 793
1 July 20X3	60 000	26 845	33 155	89 638	89 638
1 July 20X4	60 000	19 598	40 402	49 236	49 236
1 July 20X5	60 000	10 764	49 236	0	0
	<u>300 000</u>	<u>90 000</u>	<u>210 000</u>		
	(a)	(b)	(c)	(d)	(e)

The following *alternative table* has been adapted to show the balances at year-end:

W3: Finance income using effective interest rate method					
Date	Instalment	Receipt in lieu of:		Capital Balance	Debtors Balance
	A	Interest B	Capital C	210 000 – C	210 000 – A + B
1 July 20X1					210 000
1 July 20X1	60 000		60 000	150 000	150 000
31 Dec 20X1	32 793 X 6/12	16 397		150 000	166 397
1 July 20X2	32 793 X 6/12	16 396	27 207	122 793	122 793
31 Dec 20X2	26 845 X 6/12	13 423		122 793	136 216
1 July 20X3	26 845 X 6/12	13 422	33 155	89 638	89 638
31 Dec 20X3	19 598 X 6/12	9 799		89 638	99 437
1 July 20X4	19 598 X 6/12	9 799	40 402	49 236	49 236
31 Dec 20X4	10 764 X 6/12	5 382		49 236	54 618
1 July 20X5	10 764 X 6/12	5 382	49 236	0	0
	<u>300 000</u>	<u>90 000</u>	<u>210 000</u>		
	(a)	(b)	(c)	(d)	(e)

- (a) *Gross investment in finance lease: The total of this column represents the gross investment in the lease (the total amounts receivable from the lessee)*
- (b) *Unearned finance income: The total of this column represents the unearned finance income at the start of the lease and shows how this income is then earned each year*
- (c) *The total of this column represents the selling price owed by the lessee at the start of the lease and shows how this capital sum is repaid by the lessee*
- (d) *Present value of future minimum lease payments: This column represents the capital balance receivable from the lessee.*
- (e) *Net investment in finance lease: This column represents the total balance receivable from the lessee. It includes both the capital owing and the interest owing for the year, which in this example, will be paid as part of the next instalment.*

1/7/20X1	Debit	Credit
Inventory	100 000	
Bank		100 000
<i>Purchase of inventory</i>		
Cost of sale	100 000	
Inventory		100 000
<i>Inventory sold under finance lease</i>		

1/7/20X1 continued ...		Debit	Credit
Finance lease debtors – gross investment	<i>W1</i>	300 000	
Finance lease debtors – unearned finance income	<i>W1</i>		90 000
Sale	<i>W1</i>		210 000
<hr/> <i>Sale of machine under finance lease</i> <hr/>			
Bank		60 000	
Finance lease debtors – gross investment			60 000
<hr/> <i>Finance lease instalment received</i> <hr/>			
31/12/20X1			
Finance lease debtors – unearned finance income		16 397	
Finance income			16 397
<i>Finance income earned, effective interest rate table</i> <i>W2: 32 793 x 6/12 or W3: 16 397</i> <hr/>			
1/7/20X2			
Bank		60 000	
Finance lease debtors – gross investment			60 000
<hr/> <i>Finance lease instalment received</i> <hr/>			
31/12/20X2			
Finance lease debtors – unearned finance income		29 819	
Finance income			29 819
<i>Finance income earned, effective interest rate table:</i> <i>W2: 32 793 x 6/12 + 26 845 x 6/12; or W3: 16 396 + 13 423</i> <hr/>			
1/7/20X3			
Bank		60 000	
Finance lease debtors – gross investment			60 000
<hr/> <i>Finance lease instalment received</i> <hr/>			
31/12/20X3			
Finance lease debtors – unearned finance income		23 221	
Finance income			23 221
<i>Finance income earned, effective interest rate table</i> <i>W2: 26 845 x 6/12 + 19 597 x 6/12; or W3: 13 422 + 9 799</i> <hr/>			
1/7/20X4			
Bank		60 000	
Finance lease debtors – gross investment			60 000
<hr/> <i>Finance lease instalment received</i> <hr/>			
31/12/20X4			
Finance lease debtors – unearned finance income		15 181	
Finance income			15 181
<i>Finance income earned, effective interest rate table</i> <i>W2: 19 597 x 6/12 + 10 764 x 6/12; or W3: 9 799 + 5 382</i> <hr/>			
1/7/20X5			
Bank		60 000	
Finance lease debtors – gross investment			60 000
<hr/> <i>Finance lease instalment received</i> <hr/>			
31/12/20X5			
Finance lease debtors – unearned finance income		5 382	
Finance income			5 382
<i>Finance income earned, effective interest rate table</i> <i>W2: 10 764 x 6/12; or W3: 5 382</i> <hr/>			

Avocado Tree Limited
Statement of financial position
As at 31 December 20X5

		20X5	20X4	20X3	20X2	20X1
	C	C	C	C	C	C
<i>Non-current assets</i>						
Finance lease debtors: capital	15	0	0	49 236	89 639	122 793
<i>Current assets</i>						
Finance lease debtors: capital	15	0	49 236	40 402	33 155	27 207
Finance lease debtors: interest	15	0	5 382	9 799	13 423	16 397

Avocado Tree Limited
Notes to the financial statements
For the year ended 31 December 20X5

		20X5	20X4	20X3	20X2	20X1
		C	C	C	C	C
15. Finance lease debtor						
Gross investment in finance lease		0	60 000	120 000	180 000	240 000
Within 1 year	W2/3 (a)	0	60 000	60 000	60 000	60 000
After 1 year but before 5 years	W2/3 (a)	0	0	60 000	120 000	180 000
After 5 years	W2/3 (a)	0	0	0	0	0
Unearned finance income	W2/3 (b)	(0)	(5 382)	(20 563)	(43 784)	(73 603)
		(5)	(4)	(3)	(2)	(1)
Net investment in finance lease	W3 (e)	0	54 618	99 437	136 216	166 397

Represented by:

Finance income earned but receivable		0	5 382	9 799	13 423	16 397
	W2/3 (b)					
Present value of future minimum lease payments: capital repayable		0	49 236	89 638	122 793	150 000
Within 1 year	W2/3 (d)	0	49 236	40 402	33 155	27 207
Due after 1 year but before 5 years	W2/3 (d)	0	0	49 236	89 639	122 793
After 5 years	W2/3 (d)	0	0	0	0	0

(1) 90 000 – 16 397 (Jnl/ W3)

(2) 73 603 – 29 819 (Jnl/ W3)

(3) 43 784 – 23 221 (Jnl/ W3)

(4) 20 563 – 15 181 (Jnl/ W3)

(5) 5 382 – 5 382 (Jnl/ W3)

3.7 Tax implications

Finance leases will generally have deferred tax implications since most tax authorities do not differentiate between finance leases and operating leases. Rather, most tax authorities treat all leases as operating leases for income tax purposes. The tax authorities, in not recognising the substance of the finance lease (i.e. the 'sale'), hold the view that the asset belongs to the lessor and not the lessee. Therefore, the lessor is taxed on the lease instalments received less an annual deduction based on the leased asset's cost (e.g. a capital allowance of 20% of the cost of the leased asset per year). This creates a temporary difference because the lessor:

- expenses the cost of the asset in full against the income from the lease (not deducted piecemeal as is the case with capital allowances based on the cost of the leased asset); and
- recognises the instalments as sale income (if a manufacturer or dealer) and interest income using an effective interest rate table (whereas the tax authorities tax the instalments received on a cash basis).

To complicate matters further, some tax authorities do not allow the capital allowances to exceed the taxable lease income in any one period. This issue is best illustrated by an example.

Example 5: deferred tax on a finance lease

The facts from example 3 apply, repeated here for your convenience:

Pear Tree Limited is neither a dealer nor a manufacturer. Pear Tree Limited entered into an agreement in which Pear Tree leased a machine to Giant Limited (cost C210 000 on 1 January 20X3). The lease is a finance lease, the terms of which are as follows:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments: C80 000, annually in advance, payable on 1 January of each year
- guaranteed residual value: C10 000, payable on 31 December 20X3;
- interest rate implicit in the agreement: 18.7927%.

Assume further that the tax authorities:

- tax lease instalments when received;
- allow the deduction of the cost of the asset over three years (capital allowance);
- the normal income tax rate is 30%.

This is the only transaction in the years ended 31 December 20X1, 20X2 and 20X3.

Required:

Prepare the current tax and deferred tax journal entry for each of the years affected. Ignore VAT.

Solution to example 5: deferred tax on a finance lease

Comment: this example is based on the same basic facts as given in example 3. The effective interest rate table for example 3 has been repeated here for your convenience. Please see example 3 for any other calculation and/ or for the journals.

W1: Finance income using effective interest rate method

Date	Instalment A	Receipt in lieu of:		Capital Balance 210 000 – C	Debtors Balance 210 000 – A + B
		Interest B	Capital C		
01 January X1				210 000	210 000
01 January X1	80 000	0	80 000	130 000	130 000
31 December 20X1		24 431		130 000	154 431
01 January X2	80 000		55 569	74 431	74 431
31 December 20X2		13 988		74 431	88 419
01 January X3	80 000		66 012	8 419	8 419
31 December 20X3		1 581		8 419	10 000
31 December 20X3	10 000		8 419	0	0
	250 000	40 000	210 000		

W2:

Deferred tax on the machine		Carrying Amount	Tax base	Temporary difference	Deferred taxation
Opening balance	20X1	0	0	0	0
Purchase		210 000	210 000		
Finance lease disposal		(210 000)	0		
Capital allowance		0	(70 000)		
Closing balance	20X1	0	140 000	140 000	42 000 A
Capital allowance		0	(70 000)		
Closing balance	20X2	0	70 000	70 000	21 000 A
Capital allowance		0	(70 000)		
Closing balance	20X3	0	0	0	0

W3: Deferred tax on the finance lease debtor		Carrying amount	Tax base	Temporary difference	Deferred taxation
Opening balance	20X1	0	0	0	0
New lease		210 000	0		
Movement (W1)		(55 569)	0		
Closing balance (W1)	20X1	154 431	0	(154 431)	(46 329) L
Movement (W1)		(66 012)	0		
Closing balance	20X2	88 419	0	(88 419)	(26 526) L
Movement (W1)		(88 419)	0		
Closing balance (W1)	20X3	0	0	0	0

W4: Deferred tax summary		Machine (W2)	Finance lease Debtor (W3)	Total
Opening balance	20X1	0	0	0
Adjustment	20X1			(4 329) cr DT; dr TE
Closing balance	20X1	42 000	(46 329)	(4 329) L
Adjustment	20X2			(1 197) cr DT; dr TE
Closing balance	20X2	21 000	(26 526)	(5 526) L
Adjustment	20X3			5 526 dr DT; cr TE
Closing balance	20X3	0	0	0

W5: Current tax summary	20X3 C	20X2 C	20X1 C	Total C
Profit before tax:				
- Finance income earned	1 581	13 988	24 431	40 000
Adjust for permanent differences	0	0	0	0
	1 581	13 988	24 431	40 000
Adjust for temporary differences				
- less finance income	(1 581)	(13 988)	(24 431)	(40 000)
- add lease instalment received	90 000	80 000	80 000	250 000
- less capital allowance	(70 000)	(70 000)	(70 000)	(210 000)
Taxable income	20 000	10 000	10 000	40 000
Current normal tax at 30%	6 000	3 000	3 000	12 000

Journals: 31/12/20X1	Debit	Credit
Tax expense: normal tax	3 000	
Current tax payable: normal tax		3 000
<i>Current tax charge (W5)</i>		
Tax expense: normal tax	4 329	
Deferred tax: normal tax		4 329
<i>Deferred tax adjustment (W4)</i>		
31/12/20X2		
Tax expense: normal tax	3 000	
Current tax payable: normal tax		3 000
<i>Current tax charge (W5)</i>		
Tax expense: normal tax	1 197	
Deferred tax: normal tax		1 197
<i>Deferred tax adjustment (W4)</i>		

31/12/20X3	Debit	Credit
Tax expense: normal tax	6 000	
Current tax payable: normal tax		6 000
<i>Current tax charge (W5)</i>		
Deferred tax: normal tax	5 526	
Tax expense: normal tax		5 526
<i>Deferred tax adjustment (W4)</i>		

4. Operating leases (IAS 17.49 - .57)

4.1 Recognition (IAS 17.49 - .51)

An operating lease is a 'pure lease' since ownership of the asset is not transferred at any stage during the lease. The lessor therefore keeps his asset in his statement of financial position (and presents his asset according to its nature, as he would normally, e.g. as property, plant and equipment), and recognises:

- costs incurred on the lease as expenses over the period (e.g. depreciation on the leased asset where the leased asset is a depreciable asset); and
- lease instalments as income over the period of the lease.

4.2 Measurement (IAS 17.50 - .55)

The total lease income receivable should be recognised as income evenly over the period of the lease. Measurement of the income should be on the straight-line basis over the period of the lease (irrespective of the actual instalments receivable in each period). Only if there is a systematic basis that more accurately reflects the pattern in which the asset is used, should a basis other than the straight-line basis be used.

Costs (such as depreciation and impairment losses) are measured in terms of the relevant standard (e.g. IAS 16 and IAS 36 respectively).

Costs that are considered to be initial direct costs incurred in connection with the negotiating and arranging the operating lease should be added to the cost of the leased asset and thereby be expensed as the leased asset is expensed (e.g. through depreciation).

Example 6: operating lease – recognition and measurement

Banana Tree Limited entered into an operating lease with Frond Limited on 1 January 20X1. Frond Limited agreed to lease a plant from Banana Tree Limited (which had cost Banana Tree Limited C300 000 on 1 January 20X1) on the following terms:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments, payable as follows:
 - 31 December 20X1: C100 000
 - 31 December 20X2: C110 000
 - 31 December 20X3: C150 000
- Frond Limited may purchase the leased asset at its market price on 31 December 20X3
- Unguaranteed residual value: C30 000.

Frond Limited purchased the plant on 31 December 20X3 at its market price of C30 000.

Banana Tree Limited depreciates its plant over three years on the straight-line basis.

This is the only transaction in the years ended 31 December 20X1, 20X2 and 20X3.

Required:

Prepare the journal entries for each of the years affected. Ignore tax.

Solution to example 6: operating lease – recognition and measurement

		Debit	Credit
1/1/20X1			
Plant: cost	<i>Given</i>	300 000	
Bank			300 000
<i>Purchase of plant for C300 000</i>			
<hr/>			
31/12/20X1			
Depreciation – plant	$(C300\,000 - 30\,000) / 3\text{ years}$	90 000	
Plant: accumulated depreciation			90 000
<i>Depreciation of plant</i>			
<hr/>			
Bank	<i>Given</i>	100 000	
Lease income receivable		20 000	
Lease income	$(100\,000 + 110\,000 + 150\,000) / 3\text{ years}$		120 000
<i>Lease income received (average rental income over three years)</i>			
<hr/>			
31/12/20X2			
Depreciation – plant	$(C300\,000 - 30\,000) / 3\text{ years}$	90 000	
Plant: accumulated depreciation			90 000
<i>Depreciation of plant:</i>			
<hr/>			
Bank	<i>Given</i>	110 000	
Lease income receivable		10 000	
Lease income	$(80\,000 + 130\,000 + 150\,000) / 3\text{ years}$		120 000
<i>Lease income received (average rental income over three years)</i>			
<hr/>			
31/12/20X3			
Depreciation – plant	$(C300\,000 - 30\,000) / 3\text{ years}$	90 000	
Plant: accumulated depreciation			90 000
<i>Depreciation of plant:</i>			
<hr/>			
Bank	<i>Given</i>	150 000	
Lease income receivable			30 000
Lease income	$(80\,000 + 130\,000 + 150\,000) / 3\text{ years}$		120 000
<i>Lease income received (average rental income over three years)</i>			
<hr/>			
Plant: accumulated depreciation	$90\,000 \times 3\text{ years}$	270 000	
Plant: cost	<i>Given</i>		300 000
Bank	<i>Given</i>	30 000	
<i>Sale of plant at market value (also equal to residual value)</i>			

4.3 Tax implications

The tax consequences of operating leases are relatively simple to understand. The tax authorities generally:

- charge tax on the lease instalments as they are received;
- allow a deduction of the cost of the leased asset over a period of time (e.g. an annual capital allowance of 20% on the cost of the asset).

The accounting treatment involves:

- recognising income evenly over the lease period (generally on the straight-line basis);
- recognising expenses evenly over the lease period (although the rate of depreciation expense may differ from the rate of the capital allowance granted by the tax authorities).

Deferred tax consequences may therefore arise if, for example:

- the taxable lease instalment received differs from the lease income recognised;
- the costs are allowed as a tax deduction at a faster or slower rate than they are recognised as expenses;

- the initial direct costs are allowed as a tax deduction in full in the year in which they are paid while being capitalised and recognised as expenses over the lease period from an accounting profit perspective.

Example 7: operating lease – tax implications

The facts from example 8 apply, repeated here for your convenience:

FronD Limited agreed to lease a plant from Banana Tree Limited (the plant cost Banana Tree Limited C300 000 on 1 January 20X1) on the following terms:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments, payable as follows:
 - 31 December 20X1: C100 000
 - 31 December 20X2: C110 000
 - 31 December 20X3: C150 000
- FronD Limited may purchase the leased asset at its market price on 31 December 20X3
- Unguaranteed residual value: C30 000.

FronD Limited decided to purchase the plant on 31 December 20X3 (the market price was C30 000 on this date).

Banana Tree Limited depreciates its plant over three years on the straight-line basis.

This is the only transaction in the years ended 31 December 20X1, 20X2 and 20X3.

The tax authorities:

- charge tax on the lease instalments that are received;
- allow the deduction of the cost of the leased asset over three years;
- the normal income tax rate is 30%.

Required:

Prepare the related tax journals for each of the years 20X1, 20X2 and 20X3. Ignore VAT.

Solution to example 7: operating lease – tax implications

	Debit	Credit
31/12/20X1		
No current tax journal because there is no current tax charge (W4)		
Tax expense: normal tax	9 000	
Deferred tax: normal tax		9 000
<i>Deferred tax adjustment (W3)</i>		
<i>Check: tax expense in 20X1: be C9 000 (CT: 0 + DT: 9 000 = 30% x accounting profit: 30 000)</i>		
31/12/20X2		
Tax expense: normal tax	3 000	
Current tax payable: normal tax		3 000
<i>Current tax charge (W4)</i>		
Tax expense: normal tax	6 000	
Deferred tax: normal tax		6 000
<i>Deferred tax adjustment (W3)</i>		
<i>Check: tax expense in 20X2: C9 000 (CT: 3 000 + DT: 6 000 = 30% x accounting profit: 30 000)</i>		

31/12/20X3

Tax expense: normal tax	24 000	
Current tax payable: normal tax		24 000

No current tax journal because there is no current tax charge (W4)

Deferred tax: normal tax	15 000	
Tax expense: normal tax		15 000

Deferred tax adjustment (W3)

Check: tax expense in 20X3: C9 000 (CT: 24 000 – DT: 15 000 = 30% x accounting profit: 30 000)

W1: Deferred tax on the plant		Carrying amount	Tax base	Temporary difference	Deferred taxation
Opening balance	20X1	0	0	0	0
Purchase		300 000	300 000		
Depreciation and Capital allowance (cost / 3years)		(90 000)	(100 000)		
Closing balance	20X1	210 000	200 000	(10 000)	(3 000) L
Depreciation and Capital allowance (cost / 3years)		(90 000)	(100 000)		
Closing balance	20X2	120 000	100 000	(20 000)	(6 000) L
Depreciation and Capital allowance (cost / 3years)		(90 000)	(100 000)		
Carrying amount of asset that is sold (300 000 – 90 000x 3yrs)		(30 000)			
Closing balance	20X3	0	0	0	0

W2: Deferred tax on the operating lease accrual		Carrying amount	Tax base	Temporary difference	Deferred taxation
Opening balance	20X1	0	0	0	0
Movement		20 000	0		
Closing balance	20X1	20 000	0	(20 000)	(6 000) L
Movement		10 000	0		
Closing balance	20X2	30 000	0	(30 000)	(9 000) L
Movement		(30 000)	0		
Closing balance	20X3	0	0	0	0

W3: Deferred tax summary		Plant (W1)	Operating lease accrual (W2)	Total
Opening balance	20X1	0	0	0
Adjustment	20X1			(9 000) cr DT; dr TE
Closing balance	20X1	(3 000)	(6 000)	(9 000) L
Adjustment	20X2			(6 000) cr DT; dr TE
Closing balance	20X2	(6 000)	(9 000)	(15 000) L
Adjustment	20X3			15 000 dr DT; cr TE
Closing balance	20X3	0	0	0 L

W4: Current tax summary	20X3	20X2	20X1	Total
Lease rental income	120 000	120 000	120 000	360 000
Less depreciation	(90 000)	(90 000)	(90 000)	(270 000)
Add profit on sale of plant	0	0	0	0
- Proceeds on sale of plant	30 000	0	0	30 000
- Less carrying amount of plant sold	(30 000)	0	0	(30 000)
Profit before tax	30 000	30 000	30 000	90 000
Adjust for permanent differences	0	0	0	0
Adjust for temporary differences:				
- less accounting profit	(30 000)	(30 000)	(30 000)	(90 000)
- add lease instalment received	150 000	110 000	100 000	360 000
- less capital allowance	(100 000)	(100 000)	(100 000)	(300 000)
- add Profit on sale (proceeds: 30 000 – tax base: 0)	30 000	0	0	30 000
Taxable income	80 000	10 000	0	90 000
Current normal tax at 30%	24 000	3 000	0	27 000

4.4 Disclosure (IAS 17.56)

As with finance leases, operating leases require additional disclosure over and above the requirements laid down in *IFRS 7: Financial Instruments: Disclosures*. The disclosure requirements listed in IAS 17 include:

- with respect to non-cancellable operating leases: the total future minimum lease payments receivable at the end of the reporting period; and
- with respect to non-cancellable operating leases: an analysis of the future minimum lease payments receivable at the end of the reporting period into:
 - receivable within one year
 - receivable between one and five years
 - receivable later than five years;
- the total contingent rents recognised as income;
- a general description of the lessor's leasing arrangements.

The disclosure of the leased asset must be done in accordance with the standard that applies to the nature of the asset, (e.g. leased equipment will require that the equipment be disclosed in accordance with *IAS 16: Property, plant and equipment* and *IAS 36: Impairment of assets*).

Example 8: operating lease – disclosure

The facts from example 9 apply. These are repeated below for your convenience.

Banana Tree Limited entered into an operating lease with Frond Limited on 1 January 20X1. Frond Limited agreed to lease a plant from Banana Tree Limited (which had cost Banana Tree Limited C300 000 on 1 January 20X1) on the following terms:

- inception of lease: 1 January 20X1
- lease period: 3 years
- lease instalments, payable as follows:
 - 31 December 20X1: C100 000
 - 31 December 20X2: C110 000
 - 31 December 20X3: C150 000
- Frond Limited may purchase the leased asset at its market price on 31 December 20X3
- Unguaranteed residual value: C30 000.

Frond Limited decided to purchase the plant on 31 December 20X3 (the market price was C30 000 on this date).

Banana Tree Limited depreciates its plant over three years on the straight-line basis.

This is the only transaction in the years ended 31 December 20X1, 20X2 and 20X3.

Banana Tree Limited owns only this one plant.

The tax authorities:

- charge tax on the lease instalments that are received;
- allow the deduction of the cost of the leased asset over three years;
- the normal income tax rate is 30%.

Required:

Prepare the disclosure for each of the years ended 31 December 20X1, 20X2 and 20X3.

Solution to example 8: operating lease – disclosure

This is the same as example 6 and 7. Please see example 7 for the tax workings. All other workings are in example 7.

Banana Tree Limited
Statement of financial position (extracts)
As at 31 December 20X3

		20X3	20X2	20X1
		C	C	C
<i>Non-current assets</i>	<i>Notes</i>			
Plant	14	0	120 000	210 000
<i>Current assets</i>				
Operating lease income receivable (20 000 + 10 000)		0	30 000	20 000
<i>Non-current liabilities</i>				
Deferred taxation: normal tax	15	0	15 000	9 000
<i>Current liabilities</i>				
Current tax payable: normal tax		24 000	3 000	0

Banana Tree Limited
Statement of comprehensive income (extracts)
For the year ended 31 December 20X3

		20X3	20X2	20X1
		C	C	C
	<i>Notes</i>			
Profit before tax		30 000	30 000	30 000
Taxation expense	19	9 000	9 000	9 000
Profit for the year		21 000	21 000	21 000

Banana Tree Limited
Notes to the financial statements (extracts)
For the year ended 31 December 20X3

	20X3	20X2	20X1
	C	C	C
14. Plant			
Net carrying amount – 1 January	120 000	210 000	0
Gross carrying amount – 1 January	300 000	300 000	0
Less accumulated depreciation -1 January	(180 000)	(90 000)	0
• Purchase	0	0	300 000
• Depreciation	(90 000)	(90 000)	(90 000)
• Sale	(30 000)	0	0
Net carrying amount – 31 December	0	120 000	210 000
Gross carrying amount – 31 December	0	300 000	300 000
Less accumulated depreciation – 31 December	0	(180 000)	(90 000)

15. Deferred tax liability

The deferred tax constitutes temporary differences from: 0 (15 000) (9 000)

• Plant	0	(6 000)	(3 000)
• Operating lease receivable	0	(9 000)	(6 000)

16. Future minimum lease payments

Total future minimum lease payments due: 0 150 000 260 000

• Within 1 year	0	150 000	110 000
• After 1 year but before 5 years	0	0	150 000
• After 5 years	0	0	0

19. Taxation expense

Total normal tax expense 9 000 9 000 9 000

• Current normal tax – current year (<i>Example 9 W4</i>)	24 000	3 000	0
• Deferred tax – current year (<i>Example 9 W3</i>)	(15 000)	6 000	9 000

5. Summary

