

CHAPTER 21

ACCOUNTING FOR LEASES

This IFRS Supplement provides expanded discussions of accounting guidance under International Financial Reporting Standards (IFRS) for the topics in Intermediate Accounting. The discussions are organized according to the chapters in *Intermediate Accounting* (13th or 14th Editions) and therefore can be used to supplement the U.S. GAAP requirements as presented in the textbook. Assignment material is provided for each supplement chapter, which can be used to assess and reinforce student understanding of IFRS.

ACCOUNTING BY THE LESSEE

If **Air France** (FRA) (the lessee) **capitalizes** a lease, it records an asset and a liability generally equal to the present value of the rental payments. ILFC (the lessor), having transferred substantially all the benefits and risks of ownership, recognizes a sale by removing the asset from the statement of financial position and replacing it with a receivable. The typical journal entries for Air France and ILFC, assuming leased and capitalized equipment, appear as shown in Illustration 21-1.

Air France (Lessee)		ILFC (Lessor)	
Leased Equipment	XXX	Lease Receivable	XXX
Lease Liability	XXX	Equipment	XXX

ILLUSTRATION 21-1

Journal Entries for Capitalized Lease

Having capitalized the asset, Air France records depreciation on the leased asset. Both ILFC and Air France treat the lease rental payments as consisting of interest and principal.

If Air France does not capitalize the lease, it does not record an asset, nor does ILFC remove one from its books. When Air France makes a lease payment, it records rental expense; ILFC recognizes rental revenue.

A lease is classified as a **finance lease** if it transfers substantially all the risks and rewards incidental to ownership. In order to record a lease as a finance lease, the lease must be non-cancelable. The IASB identifies the four criteria listed in Illustration 21-2 for assessing whether the risks and rewards have been transferred in the lease arrangement.

U.S. GAAP PERSPECTIVE



U.S. GAAP for leases uses bright-line criteria to determine if a lease arrangement transfers the risks and rewards of ownership; IFRS is more general in its provisions.

Capitalization Criteria (Lessee)

1. The lease transfers ownership of the property to the lessee.
2. The lease contains a bargain-purchase option.¹
3. The lease term is for the major part of the economic life of the asset.
4. The present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. [1]

ILLUSTRATION 21-2

Capitalization Criteria for Lessee

¹We define a bargain-purchase option in the next section.

Air France classifies and accounts for leases that **do not meet any of the four criteria as operating leases**. Illustration 21-3 shows that a lease meeting any one of the four criteria results in the lessee having a finance lease.²

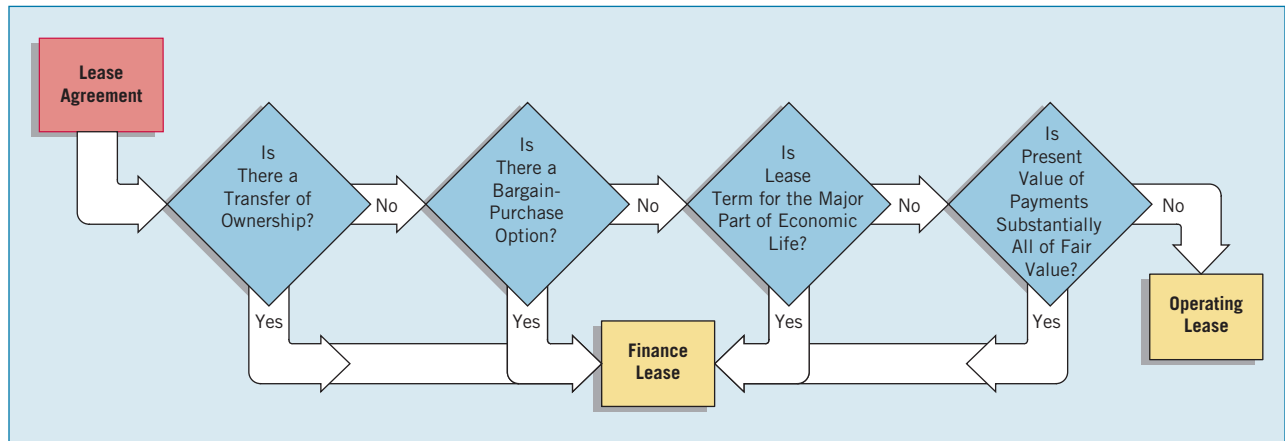


ILLUSTRATION 21-3
Diagram of Lessee's
Criteria for Lease
Classification

Thus, the proper classification of a lease is determined based on the substance of the lease transaction, rather than on its mere form. This determination often requires the use of professional judgment of whether the risks and rewards of ownership are transferred.

Capitalization Criteria

Three of the four **capitalization criteria** that apply to lessees are controversial and can be difficult to apply in practice. We discuss each of the criteria in detail on the following pages.

U.S. GAAP PERSPECTIVE



Much of the terminology for lease accounting in IFRS and U.S. GAAP is the same. One difference is that finance leases are referred to as capital leases in U.S. GAAP.

Transfer of Ownership Test

If the lease transfers ownership of the asset to the lessee, it is a finance lease. This criterion is not controversial and easily implemented in practice.

Bargain-Purchase Option Test

A **bargain-purchase option** allows the lessee to purchase the leased property for a price that is **significantly lower** than the property's expected fair value at the date the option becomes exercisable. At the inception of the lease, the difference between the option price and the expected fair value must be large enough to make exercise of the option reasonably assured.

For example, assume that Brett's Delivery Service was to lease a Honda Accord for \$599 per month for 40 months, with an option to purchase for \$100 at the end of the 40-month period. If the estimated fair value of the Honda Accord is \$3,000 at the end

²A fifth criterion applies to the relatively less common setting in which the leased asset is of such a specialized nature that only the lessee can use it without major modifications. If a lease involves an asset with these characteristics, then the risks and rewards of ownership are likely to transfer. In addition to the determinative criteria, lessees and lessors should also consider the following indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease: (1) the lessee can cancel the lease, and the lessor's losses associated with the cancellation are borne by the lessee; (2) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and (3) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent. [2]

of the 40 months, the \$100 option to purchase is clearly a bargain. Therefore, Brett must capitalize the lease. In other cases, the criterion may not be as easy to apply, and determining *now* that a certain *future* price is a bargain can be difficult.

Economic Life Test

If the lease period is for a major part of the asset's economic life, the lessor transfers most of the risks and rewards of ownership to the lessee. Capitalization is therefore appropriate. However, determining the lease term and what constitutes the major part of the economic life of the asset can be troublesome.

The IASB has not defined what is meant by the "major part" of an asset's economic life. In practice, following the IASB hierarchy, it has been customary to look to U.S. GAAP, which has a 75 percent of economic life threshold for evaluating the economic life test. While the 75 percent guideline may be a useful reference point, it does not represent an automatic cutoff point. Rather, lessees and lessors should consider all relevant factors when assessing whether substantially all the risks and rewards of ownership have been transferred in the lease.³ *For purposes of homework, assume a 75 percent threshold for the economic life test, unless otherwise stated.*

The **lease term** is generally considered to be the fixed, non-cancelable term of the lease. However, a bargain-renewal option, if provided in the lease agreement, can extend this period. A **bargain-renewal option** allows the lessee to renew the lease for a rental that is lower than the expected fair rental at the date the option becomes exercisable. At the inception of the lease, the difference between the renewal rental and the expected fair rental must be great enough to make exercise of the option to renew reasonably assured. [3]

For example, assume that **Carrefour** (FRA) leases **Lenovo** (CHN) PCs for two years at a rental of €100 per month per computer and subsequently can lease them for €10 per month per computer for another two years. The lease clearly offers a bargain-renewal option; the lease term is considered to be four years. However, with bargain-renewal options, as with bargain-purchase options, it is sometimes difficult to determine what is a bargain.

Determining estimated economic life can also pose problems, especially if the leased item is a specialized item or has been used for a significant period of time. For example, determining the economic life of a nuclear core is extremely difficult. It is subject to much more than normal "wear and tear."

Recovery of Investment Test

If the present value of the minimum lease payments equals or exceeds substantially all of the fair value of the asset, then a lessee like Air France should capitalize the leased asset. Why? If the present value of the minimum lease payments is reasonably close to the fair value of the aircraft, Air France is effectively purchasing the asset.

As with the economic life test, the IASB has not defined what is meant by "substantially all" of an asset's fair value. In practice, it has been customary to look to U.S. GAAP, which has a 90 percent of fair value threshold for assessing the recovery of investment test. Again, rather than focusing on any single element of the lease classification indicators, lessees and lessors should consider all relevant factors when evaluating lease classification criteria.⁴ *For purposes of homework, assume a 90 percent threshold for the recovery of investment test.*

³See KPMG, *Insights into IFRS*, Fifth Edition (Thomson Reuters: London, 2008), pp. 1011; and The International Financial Reporting Group of Ernst and Young, *International GAAP, 2009* (John Wiley and Sons: New York, 2009), p. 1356.

⁴*Ibid.* The 75 percent of useful life and 90 percent of fair value "bright-line" cutoffs in U.S. GAAP have been criticized. Many believe that lessees structure leases so as to just miss the 75 and 90 percent cutoffs, avoiding classifying leases as finance leases, thereby keeping leased assets and the related liabilities off the statement of financial position. See Warren McGregor, "Accounting for Leases: A New Approach," Special Report (Norwalk, Conn.: FASB, 1996).

Determining the present value of the minimum lease payments involves three important concepts: (1) minimum lease payments, (2) executory costs, and (3) discount rate.

Minimum Lease Payments. Air France is obligated to make, or expected to make, **minimum lease payments** in connection with the leased property. These payments include the following. [4]

1. **Minimum rental payments.** Minimum rental payments are those that Air France must make to ILFC under the lease agreement. In some cases, the minimum rental payments may equal the minimum lease payments. However, the minimum lease payments may also include a guaranteed residual value (if any), penalty for failure to renew, or a bargain-purchase option (if any), as we note below.
2. **Guaranteed residual value.** The residual value is the estimated fair value of the leased property at the end of the lease term. ILFC may transfer the risk of loss to Air France or to a third party by obtaining a guarantee of the estimated residual value. The **guaranteed residual value** is either (1) the certain or determinable amount that Air France will pay ILFC at the end of the lease to purchase the aircraft at the end of the lease, or (2) the amount Air France guarantees that ILFC will realize if the aircraft is returned. If not guaranteed in full, the **unguaranteed residual value** is the estimated residual value exclusive of any portion guaranteed.⁵
3. **Penalty for failure to renew or extend the lease.** The amount Air France must pay if the agreement specifies that it must extend or renew the lease, and it fails to do so.
4. **Bargain-purchase option.** As we indicated earlier (in item 1), an option given to Air France to purchase the aircraft at the end of the lease term at a price that is fixed sufficiently below the expected fair value, so that, at the inception of the lease, purchase is reasonably assured.

Air France excludes executory costs (defined below) from its computation of the present value of the minimum lease payments.

Executory Costs. Like most assets, leased tangible assets incur insurance, maintenance, and tax expenses—called **executory costs**—during their economic life. If ILFC retains responsibility for the payment of these “ownership-type costs,” **it should exclude**, in computing the present value of the minimum lease payments, the portion of each lease payment that represents executory costs. Executory costs do not represent payment on or reduction of the obligation.

Many lease agreements specify that the lessee directly pays executory costs to the appropriate third parties. In these cases, the lessor can use the rental payment **without adjustment** in the present value computation.

Discount Rate. A lessee, like Air France, computes the present value of the minimum lease payments using the **implicit interest rate**. [6] This rate is defined as 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 fair value of the leased asset. [7]

While Air France may argue that it cannot determine the implicit rate of the lessor, in most cases Air France can approximate the implicit rate used by ILFC. In the event that it is impracticable to determine the implicit rate, Air France should use its incremental borrowing rate. The **incremental borrowing rate** is the rate of interest the lessee would

U.S. GAAP PERSPECTIVE



IFRS requires that lessees use the implicit rate to record a lease unless it is impractical to determine the lessor's implicit rate. U.S. GAAP requires use of the incremental rate unless the implicit rate is known by the lessee and the implicit rate is lower than the incremental rate.

⁵If the residual value is guaranteed by a third party, it is not included in the minimum lease payments. (**Third-party guarantors** are, in essence, insurers who for a fee assume the risk of deficiencies in leased asset residual value.) A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is not included in the minimum lease payments. Lessees recognize such costs as period costs when incurred. As noted earlier, such a provision could be an indicator that a lease should be classified as a finance lease. [5]

have to pay on a similar lease or the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term the funds necessary to purchase the asset.

If known or practicable to estimate, use of the implicit rate is preferred. This is because **the implicit rate of ILFC is generally a more realistic rate** to use in determining the amount (if any) to report as the asset and related liability for Air France. In addition, use of the implicit rate avoids use of **an artificially high incremental borrowing rate** that would cause the present value of the minimum lease payments to be lower, supporting an argument that the lease does not meet the recovery of investment test. Use of such a rate would thus make it more likely that the lessee avoids capitalization of the leased asset and related liability.

Air France may argue that it cannot determine the implicit rate of the lessor and therefore should use the higher incremental rate. However, in most cases, Air France can approximate the implicit rate used by ILFC. The determination of whether or not a reasonable estimate could be made will require judgment, particularly where the result from using the incremental borrowing rate comes close to meeting the fair value test. Because Air France **may not capitalize the leased property at more than its fair value** (as we discuss later), it cannot use an excessively low discount rate.

Asset and Liability Accounted for Differently

In a finance lease transaction, Air France uses the lease as a source of financing. ILFC finances the transaction (provides the investment capital) through the leased asset. Air France makes rent payments, which actually are installment payments. Therefore, over the life of the aircraft rented, **the rental payments to ILFC constitute a payment of principal plus interest.**

Asset and Liability Recorded

Under the finance lease method, Air France treats the lease transaction as if it purchases the aircraft in a financing transaction. That is, Air France acquires the aircraft and creates an obligation. Therefore, it records a finance lease as an asset and a liability at either (1) the present value of the minimum lease payments (excluding executory costs) or (2) the fair value of the leased asset at the inception of the lease. The rationale for this approach is that companies should not record a leased asset for more than its fair value.

Depreciation Period

One troublesome aspect of accounting for the depreciation of the capitalized leased asset relates to the period of depreciation. If the lease agreement transfers ownership of the asset to Air France (criterion 1) or contains a bargain-purchase option (criterion 2), Air France depreciates the aircraft consistent with its normal depreciation policy for other aircraft, **using the economic life of the asset.**

On the other hand, if the lease does not transfer ownership or does not contain a bargain-purchase option, then Air France depreciates it over the **term of the lease.** In this case, the aircraft reverts to ILFC after a certain period of time.

Effective-Interest Method

Throughout the term of the lease, Air France uses the **effective-interest method** to allocate each lease payment between principal and interest. This method produces a periodic interest expense equal to a constant percentage of the carrying value of the lease obligation. When applying the effective-interest method to finance leases, Air France must use the same discount rate that determines the present value of the minimum lease payments.

Depreciation Concept

Although Air France computes the amounts initially capitalized as an asset and recorded as an obligation at the same present value, the **depreciation of the aircraft and the discharge of the obligation are independent accounting processes** during the term of the lease. It should depreciate the leased asset by applying conventional depreciation methods: straight-line, sum-of-the-years'-digits, declining-balance, units of production, etc.

Finance Lease Method (Lessee)

To illustrate a finance lease, assume that **CNH Capital** (NLD) (a subsidiary of CNH Global) and **Ivanhoe Mines Ltd.** (CAN) sign a lease agreement dated January 1, 2012, that calls for CNH to lease a front-end loader to Ivanhoe beginning January 1, 2012. The terms and provisions of the lease agreement, and other pertinent data, are as follows.

- The term of the lease is five years. The lease agreement is non-cancelable, requiring equal rental payments of \$25,981.62 at the beginning of each year (annuity-due basis).
- The loader has a fair value at the inception of the lease of \$100,000, an estimated economic life of five years, and no residual value.
- Ivanhoe pays all of the executory costs directly to third parties except for the property taxes of \$2,000 per year, which is included as part of its annual payments to CNH.
- The lease contains no renewal options. The loader reverts to CNH at the termination of the lease.
- Ivanhoe’s incremental borrowing rate is 11 percent per year.
- Ivanhoe depreciates similar equipment that it owns on a straight-line basis.
- CNH sets the annual rental to earn a rate of return on its investment of 10 percent per year; Ivanhoe knows this fact.

The lease meets the criteria for classification as a finance lease for the following reasons:

1. The lease term of five years, being equal to the equipment’s estimated economic life of five years, satisfies the economic life test.
2. The present value of the minimum lease payments (\$100,000 as computed below) equals the fair value of the loader (\$100,000).

The minimum lease payments are \$119,908.10 ($\$23,981.62 \times 5$). Ivanhoe computes the amount capitalized as leased assets as the present value of the minimum lease payments (excluding executory costs—property taxes of \$2,000) as shown in Illustration 21-4.

ILLUSTRATION 21-4

Computation of Capitalized Lease Payments

$$\begin{aligned}
 \text{Capitalized amount} &= (\$25,981.62 - \$2,000) \times \text{Present value of an annuity due of 1 for} \\
 &\qquad\qquad\qquad 5 \text{ periods at } 10\% \text{ (Table 6-5)} \\
 &= \$23,981.62 \times 4.16986 \\
 &= \mathbf{\$100,000}
 \end{aligned}$$

Calculator Solution for Lease Payment

	Inputs	Answer
N	5	
I	10	
PV	?	100,000
PMT	-23,981.59	
FV	0	

Ivanhoe uses CNH’s implicit interest rate of 10 percent instead of its incremental borrowing rate of 11 percent because it knows about it.⁶ Ivanhoe records the finance lease on its books on January 1, 2012, as:

Leased Equipment under Finance Leases	100,000	
Lease Liability		100,000

Note that the entry records the obligation at the net amount of \$100,000 (the present value of the future rental payments) rather than at the gross amount of \$119,908.10 ($\$23,981.62 \times 5$).

Ivanhoe records the **first lease payment on January 1, 2012**, as follows.

Property Tax Expense	2,000.00	
Lease Liability	23,981.62	
Cash		25,981.62

⁶If it is impracticable for Ivanhoe to determine the implicit rate and it has an incremental borrowing rate of, say, 9 percent (lower than the 10 percent rate used by CNH), the present value computation would yield a capitalized amount of \$101,675.35 ($\$23,981.62 \times 4.23972$). Thus, use of an unrealistically low discount rate could lead to a lessee recording a leased asset at an amount exceeding the fair value of the equipment, which is generally prohibited in IFRS. This explains why the implicit rate should be used to capitalize the minimum lease payments.

Each lease payment of \$25,981.62 consists of three elements: (1) a reduction in the lease liability, (2) a financing cost (interest expense), and (3) executory costs (property taxes). The total financing cost (interest expense) over the term of the lease is \$19,908.10. This amount is the difference between the present value of the lease payments (\$100,000) and the actual cash disbursed, net of executory costs (\$119,908.10). The annual interest expense, applying the effective-interest method, is a function of the outstanding liability, as Illustration 21-5 shows.

IVANHOE MINES					
LEASE AMORTIZATION SCHEDULE					
ANNUITY-DUE BASIS					
Date	Annual Lease Payment	Executory Costs	Interest (10%) on Liability	Reduction of Lease Liability	Lease Liability
	(a)	(b)	(c)	(d)	(e)
1/1/12					\$100,000.00
1/1/12	\$ 25,981.62	\$ 2,000	\$ -0-	\$ 23,981.62	76,018.38
1/1/13	25,981.62	2,000	7,601.84	16,379.78	59,638.60
1/1/14	25,981.62	2,000	5,963.86	18,017.76	41,620.84
1/1/15	25,981.62	2,000	4,162.08	19,819.54	21,801.30
1/1/16	25,981.62	2,000	2,180.32*	21,801.30	-0-
	<u>\$129,908.10</u>	<u>\$10,000</u>	<u>\$19,908.10</u>	<u>\$100,000.00</u>	

(a) Lease payment as required by lease.
 (b) Executory costs included in rental payment.
 (c) Ten percent of the preceding balance of (e) except for 1/1/12; since this is an annuity due, no time has elapsed at the date of the first payment and no interest has accrued.
 (d) (a) minus (b) and (c).
 (e) Preceding balance minus (d).
 *Rounded by 19 cents.

ILLUSTRATION 21-5
Lease Amortization
Schedule for Lessee—
Annuity-Due Basis

At the end of its fiscal year, December 31, 2012, Ivanhoe records **accrued interest** as follows.

Interest Expense	7,601.84	
Interest Payable		7,601.84

Depreciation of the leased equipment over its five-year lease term, applying Ivanhoe's normal depreciation policy (straight-line method), results in the following entry on December 31, 2012.

Depreciation Expense—Finance Leases	20,000	
Accumulated Depreciation—Finance Leases		20,000
	(\$100,000 ÷ 5 years)	

At December 31, 2012, Ivanhoe separately identifies the assets recorded under finance leases on its statement of financial position. Similarly, it separately identifies the related obligations. Ivanhoe classifies the portion due within one year or the operating cycle, whichever is longer, with current liabilities, and the rest with non-current liabilities. For example, the current portion of the December 31, 2012, total obligation of \$76,018.38 in Ivanhoe's amortization schedule is the amount of the reduction in the obligation in 2013, or \$16,379.78. Illustration 21-6 shows the liabilities section as it relates to lease transactions at December 31, 2012.

<u>Non-current liabilities</u>	
Lease liability (\$76,018.38 - \$16,379.78)	\$59,638.60
<u>Current liabilities</u>	
Interest payable	\$ 7,601.84
Lease liability	16,379.78

ILLUSTRATION 21-6
Reporting Current and
Non-Current Lease
Liabilities

Ivanhoe records the lease payment of January 1, 2013, as follows.

Property Tax Expense	2,000.00	
Interest Payable	7,601.84	
Lease Liability	16,379.78	
Cash		25,981.62

Entries through 2016 would follow the pattern above. Ivanhoe records its other executory costs (insurance and maintenance) in a manner similar to how it records any other operating costs incurred on assets it owns.

Upon expiration of the lease, Ivanhoe has fully depreciated the amount capitalized as leased equipment. It also has fully discharged its lease obligation. If Ivanhoe does not purchase the loader, it returns the equipment to CNH. Ivanhoe then removes the leased equipment and related accumulated depreciation accounts from its books.

If Ivanhoe purchases the equipment at termination of the lease, at a price of \$5,000 and the estimated life of the equipment changes from five to seven years, it makes the following entry.

Equipment (\$100,000 + \$5,000)	105,000	
Accumulated Depreciation—Finance Leases	100,000	
Leased Equipment under Finance Leases		100,000
Accumulated Depreciation—Equipment		100,000
Cash		5,000

Classification of Leases by the Lessor

For accounting purposes, the **lessor** also classifies leases as operating or finance leases. Finance leases may be further subdivided into direct-financing and sales-type leases.

As with lessee accounting, if the lease transfers substantially all the risks and rewards incidental to ownership, the lessor shall classify and account for the arrangement as a finance lease. Lessors evaluate the same criteria shown in Illustration 21-2 to make this determination.

The distinction for the lessor between a direct-financing lease and a sales-type lease is the presence or absence of a manufacturer's or dealer's profit (or loss): A sales-type lease involves a manufacturer's or dealer's profit, and a direct-financing lease does not. The profit (or loss) to the lessor is evidenced by the difference between the fair value of the leased property at the inception of the lease and the lessor's cost or carrying amount (book value).

Normally, sales-type leases arise when manufacturers or dealers use leasing as a means of marketing their products. For example, a computer manufacturer will lease its computer equipment (possibly through a captive) to businesses and institutions. Direct-financing leases generally result from arrangements with lessors that are primarily engaged in financing operations (e.g., banks).

Lessors classify and account for all leases that do not qualify as direct-financing or sales-type leases as operating leases. Illustration 21-7 shows the circumstances under which a lessor classifies a lease as operating, direct-financing, or sales-type.

For purposes of comparison with the lessee's accounting, we will illustrate only the operating and direct-financing leases in the following section. We will discuss the more complex sales-type lease later in the chapter.

Direct-Financing Method (Lessor)

Direct-financing leases are in substance the financing of an asset purchase by the lessee. In this type of lease, the lessor records a **lease receivable** instead of a leased asset. The lease receivable is the present value of the minimum lease payments plus the present value of the unguaranteed residual value. Remember that "minimum lease payments" include:

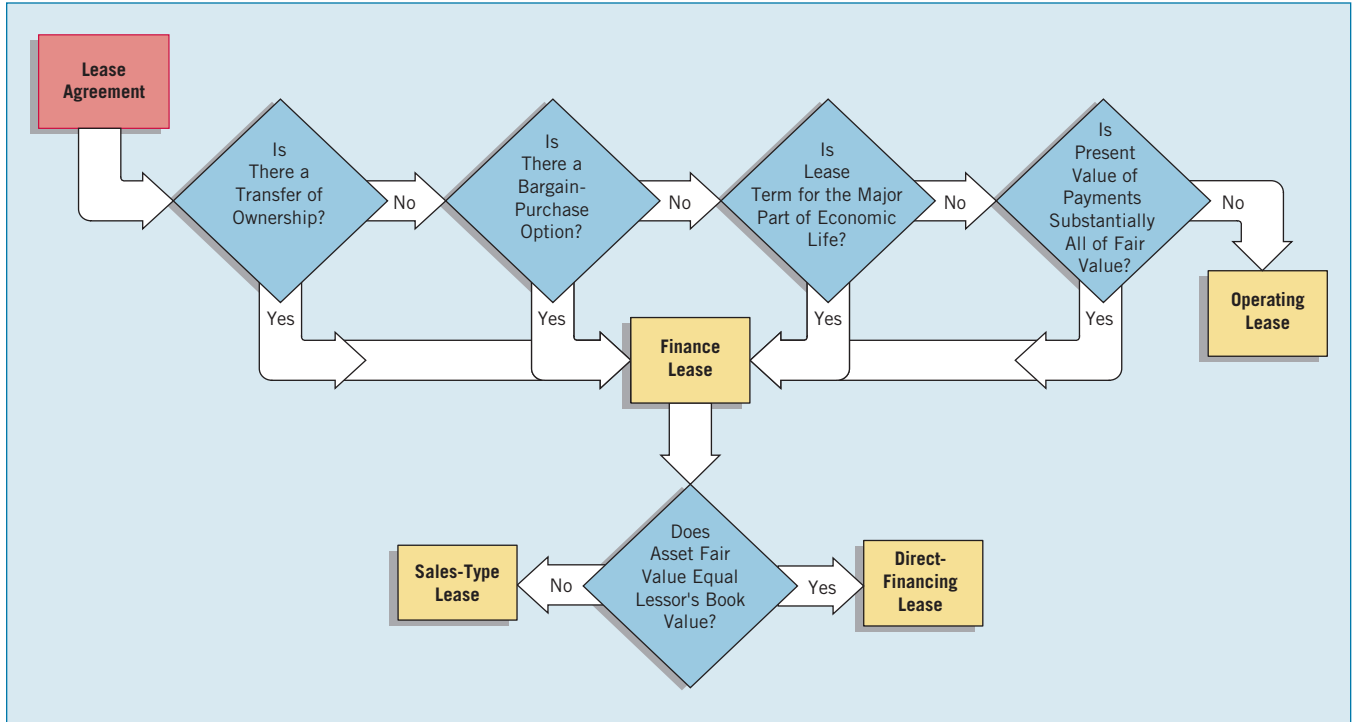


ILLUSTRATION 21-7

Diagram of Lessor's Criteria for Lease Classification

- (1) rental payments (excluding executory costs), (2) bargain-purchase option (if any), (3) guaranteed residual value (if any), and (4) penalty for failure to renew (if any).

Thus, the lessor records the residual value, whether guaranteed or not. Also, recall that if the lessor pays any executory costs, then it should reduce the rental payment by that amount in computing minimum lease payments.

The following presentation, using the data from the preceding CNH/Ivanhoe example on pages 1129–1131, illustrates the accounting treatment for a direct-financing lease. We repeat here the information relevant to CNH in accounting for this lease transaction.

1. The term of the lease is five years beginning January 1, 2012, non-cancelable, and requires equal rental payments of \$25,981.62 at the beginning of each year. Payments include \$2,000 of executory costs (property taxes).
2. The equipment (front-end loader) has a cost of \$100,000 to CNH, a fair value at the inception of the lease of \$100,000, an estimated economic life of five years, and no residual value.
3. CNH incurred no initial direct costs in negotiating and closing the lease transaction.
4. The lease contains no renewal options. The equipment reverts to CNH at the termination of the lease.
5. CNH sets the annual lease payments to ensure a rate of return of 10 percent (implicit rate) on its investment, as shown in Illustration 21-8.

U.S. GAAP PERSPECTIVE



Under IFRS, lessees and lessors use the same lease capitalization criteria to determine if the risks and rewards of ownership have been transferred to the lease. U.S. GAAP has additional lessor guidelines that payments are collectible and there are no additional costs associated with a lease.

Fair value of leased equipment	\$100,000.00
Less: Present value of residual value	—
Amount to be recovered by lessor through lease payments	<u>\$100,000.00</u>
Five beginning-of-the-year lease payments to yield a 10% return (\$100,000 ÷ 4.16986 ^a)	<u>\$ 23,981.62</u>

^aPV of an annuity due of 1 for 5 years at 10% (Table 6-5).

ILLUSTRATION 21-8

Computation of Lease Payments

As shown in the earlier analysis, the lease meets the criteria for classification as a direct-financing lease for two reasons: (1) The lease term equals the equipment’s estimated economic life, and (2) the present value of the minimum lease payments equals the equipment’s fair value. It is not a sales-type lease because there is no difference between the fair value (\$100,000) of the loader and CNH’s cost (\$100,000).

The Lease Receivable is the present value of the minimum lease payments (excluding executory costs which are property taxes of \$2,000). CNH computes it as follows.

ILLUSTRATION 21-9
Computation of Lease Receivable

$$\begin{aligned}
 \text{Lease receivable} &= (\$25,981.62 - \$2,000) \times \text{Present value of an annuity due of 1 for 5} \\
 &\qquad\qquad\qquad \text{periods at 10\% (Table 6-5)} \\
 &= \$23,981.62 \times 4.16986 \\
 &= \mathbf{\$100,000}
 \end{aligned}$$

CNH records the lease of the asset and the resulting receivable on January 1, 2012 (the inception of the lease), as follows.

Lease Receivable	100,000
Equipment	100,000

Companies often **report** the lease receivable in the statement of financial position as “Net investment in finance leases.” Companies classify it either as current or non-current, depending on when they recover the net investment.⁷

CNH replaces its investment (the leased front-end loader, a cost of \$100,000) with a lease receivable. In a manner similar to Ivanhoe’s treatment of interest, CNH applies the effective-interest method and recognizes interest revenue as a function of the lease receivable balance, as Illustration 21-10 shows.

ILLUSTRATION 21-10
Lease Amortization Schedule for Lessor—Annuity-Due Basis

CNH CAPITAL					
LEASE AMORTIZATION SCHEDULE					
ANNUITY-DUE BASIS					
Date	Annual Lease Payment	Executory Costs	Interest (10%) on Lease Receivable	Lease Receivable Recovery	Lease Receivable
	(a)	(b)	(c)	(d)	(e)
1/1/12					\$100,000.00
1/1/12	\$ 25,981.62	\$ 2,000.00	\$ –0–	\$ 23,981.62	76,018.38
1/1/13	25,981.62	2,000.00	7,601.84	16,379.78	59,638.60
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1/1/15	25,981.62	2,000.00	4,162.08	19,819.54	21,801.30
1/1/16	25,981.62	2,000.00	2,180.32*	21,801.30	–0–
	<u>\$129,908.10</u>	<u>\$10,000.00</u>	<u>\$19,908.10</u>	<u>\$100,000.00</u>	

(a) Annual rental that provides a 10% return on net investment.
 (b) Executory costs included in rental payment.
 (c) Ten percent of the preceding balance of (e) except for 1/1/12.
 (d) (a) minus (b) and (c).
 (e) Preceding balance minus (d).
 *Rounded by 19 cents.

On January 1, 2012, CNH records receipt of the first year’s lease payment as follows.

Cash	25,981.62
Lease Receivable	23,981.62
Property Tax Expense/Property Taxes Payable	2,000.00

⁷In the notes to the financial statements, the lease receivable is reported at its gross amount (minimum lease payments plus the unguaranteed residual value). In addition, the lessor also reports total unearned interest related to the lease. As a result, some lessors record lease receivable on a gross basis and record the unearned interest in a separate account. We illustrate the net approach here because it is consistent with the accounting for the lessee.

On December 31, 2012, CNH recognizes the interest revenue earned during the first year through the following entry.

Interest Receivable	7,601.84	
Interest Revenue—Leases		7,601.84

At December 31, 2012, CNH reports the lease receivable in its statement of financial position among current assets or non-current assets, or both. It classifies the portion due within one year or the operating cycle, whichever is longer, as a current asset, and the rest with non-current assets.

Illustration 21-11 shows the assets section as it relates to lease transactions at December 31, 2012.

<u>Non-current assets (investments)</u>	
Lease receivable (\$76,018.38 – \$16,379.78)	\$59,638.60
<u>Current assets</u>	
Interest receivable	\$ 7,601.84
Lease receivable	16,379.78

ILLUSTRATION 21-11
Reporting Lease
Transactions by Lessor

The following entries record receipt of the second year's lease payment and recognition of the interest earned.

January 1, 2013		
Cash	25,981.62	
Lease Receivable		16,379.78
Interest Receivable		7,601.84
Property Tax Expense/Property Taxes Payable		2,000.00
December 31, 2013		
Interest Receivable	5,963.86	
Interest Revenue—Leases		5,963.86

Journal entries through 2016 follow the same pattern except that CNH records no entry in 2016 (the last year) for earned interest. Because it fully collects the receivable by January 1, 2016, no balance (investment) is outstanding during 2016. CNH recorded no depreciation. If Ivanhoe buys the loader for \$5,000 upon expiration of the lease, CNH recognizes disposition of the equipment as follows.

Cash	5,000	
Gain on Sale of Leased Equipment		5,000

Disclosing Lease Data

In addition to the amounts reported in the financial statements related to lease assets and liabilities, the IASB requires **lessees** and **lessors** to disclose certain information about leases. These requirements vary based upon the type of lease (finance or operating) and whether the issuer is the lessor or lessee. These disclosure requirements provide investors with the following information:

For lessees: [8]

- A general description of material leasing arrangements.
- A reconciliation between the total of future minimum lease payments at the end of the reporting period and their present value.

- The total of future minimum lease payments at the end of the reporting period, and their present value for periods (1) not later than one year, (2) later than one year and not later than five years, and (3) later than five years.

For lessors: [9]

- A general description of material leasing arrangements.
- A reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period.
- Unearned finance income.
- The gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period for periods (1) not later than one year, (2) later than one year and not later than five years, and (3) later than five years.

Illustration 21-12 presents financial statement excerpts from the 2008 annual report of **Delhaize Group** (BEL). These excerpts represent the statement and note disclosures typical of a lessee having both finance leases and operating leases.

ILLUSTRATION 21-12
Disclosure of Leases by Lessee



Delhaize Group

(euro amounts in millions)

<u>Non-Current Liabilities</u>	<u>2008</u>
Long-term obligations under finance leases, less current portion	€643
<u>Current Liabilities</u>	
Current obligations under finance leases	€ 44

19. Leases

Delhaize Group's stores operate principally in leased premises. Lease terms generally range from one to 30 years with renewal options ranging from three to 27 years. The schedule below provides the future minimum lease payments, which have not been reduced by minimum sublease income of €88 million due over the term of non-cancellable subleases, as of December 31, 2008:

(in million of euro)	2009	2010-2013	Thereafter	Total
Finance leases				
Future minimum lease payments	122	436	919	1,477
Less amount representing interest	(78)	(262)	(450)	(790)
Present value of minimum lease payments	44	174	469	687
Operating leases				
Future minimum lease payments (for non-cancellable leases)	241	812	1,132	2,185
Closed store lease obligations				
Future minimum lease payments	13	34	22	69

The average effective interest rate for finance leases was 11.9% at December 31, 2008. The fair value of the Group's finance lease obligations using an average market rate of 8.3% at December 31, 2008 was €817 million.

Rent payments, including scheduled rent increases, are recognized on a straight-line basis over the minimum lease term. Total rent expense under operating leases was €245 million in 2008, being included predominately in "Selling, general and administrative expenses." Certain lease agreements also include contingent rent requirements which are generally based on store sales. Contingent rent expense recognized in 2008 amounted €1 million.

General description

Reconciliation, timing, and amounts of cash outflows

Additional information

Illustration 21-13 presents the lease note disclosure from the 2009 annual report of **Trinity Biotech plc** (IRL). The disclosure highlights required lessor disclosures.



Trinity Biotech

Notes to Financial Statements

(in millions)

Note 16: Trade and Other Receivables (in part)

Finance Lease Commitments

The Group leases instruments as part of its business. Future minimum finance lease receivables with non-cancellable terms are as follows:

	December 31, 2009 US\$'000		
	Gross Investment	Unearned Income	Minimum Payments Receivable
Less than one year	1,002	310	692
Between one and five years	1,559	453	1,106
	<u>2,561</u>	<u>763</u>	<u>1,798</u>

Operating Lease Commitments

The Group has leased a facility consisting of 9,000 square feet in Dublin, Ireland. This property has been sublet by the Group. The lease contains a clause to enable upward revision of the rent charge on a periodic basis. The Group also leases instruments under operating leases as part of its business. Future minimum rentals receivable under non-cancellable operating leases are as follows:

	December 31, 2009 US\$'000		
	Land and Buildings	Instruments	Total
Less than one year	228	1,992	2,220
Between one and five years	911	852	1,763
More than five years	399	—	399
	<u>1,538</u>	<u>2,844</u>	<u>4,382</u>

ILLUSTRATION 21-13

Disclosure of Leases by Lessor

General description

Reconciliation and timing of amounts receivable and unearned revenue

Description of leased assets

Nature, timing, and amounts of future rentals

SALE-LEASEBACKS

The term **sale-leaseback** describes a transaction in which the owner of the property (seller-lessee) sells the property to another and simultaneously leases it back from the new owner. The use of the property is generally continued without interruption.

Sale-leasebacks are common. Financial institutions (e.g., **HSBC** (GBR) and **BBVA** (ESP)) have used this technique for their administrative offices, retailers (**Liberty** (GBR)) for their stores, and hospitals (**Healthscope** (AUS)) for their facilities. The advantages of a sale-leaseback from the seller's viewpoint usually involve two primary considerations:

- 1. Financing**—If the purchase of equipment has already been financed, a sale-leaseback can allow the seller to refinance at lower rates, assuming rates have dropped. In addition, a sale-leaseback can provide another source of working capital, particularly when liquidity is tight.
- 2. Taxes**—At the time a company purchased equipment, it may not have known that it would be subject to certain tax laws and that ownership might increase its minimum tax liability. By selling the property, the seller-lessee may deduct the entire lease payment, which is not subject to these tax considerations.

Determining Asset Use

To the extent the **seller-lessee continues to use** the asset after the sale, the sale-leaseback is really a form of financing. Therefore, the lessor **should not recognize a gain or loss** on the transaction. In short, the seller-lessee is simply borrowing funds.



Underlying Concepts

A sale-leaseback is similar in substance to the parking of inventories (discussed in Chapter 8). The ultimate economic benefits remain under the control of the “seller,” thus satisfying the definition of an asset.

On the other hand, if the **seller-lessee gives up the right to the use** of the asset, the transaction is in substance a sale. In that case, **gain or loss recognition** is appropriate. Trying to ascertain when the lessee has given up the use of the asset is difficult, however, and the IASB has formulated complex rules to identify this situation.⁸ To understand the profession’s position in this area, we discuss the basic accounting for the lessee and lessor below.

Lessee

If the lease meets one of the four criteria for treatment as a finance lease (see Illustration 21-3 on page 1125), the **seller-lessee accounts for the transaction as a sale and the lease as a finance lease**. The seller-lessee should defer any profit or loss it experiences from the sale of the assets that are leased back under a finance lease; it should **amortize that profit over the lease term** (or the economic life if either criterion 1 or 2 is satisfied) in proportion to the depreciation of the leased assets.

For example, assume **Stora Enso** (FIN) sells equipment having a book value of €580,000 and a fair value of €623,110 to **Deutsche Bank** (DEU) for €623,110 and leases the equipment back for €50,000 a year for 20 years. Stora Enso should amortize the profit of €43,110 over the 20-year period at the same rate that it depreciates the €623,110. **[10]** It credits the €43,110 (€623,110 – €580,000) to **Unearned Profit on Sale-Leaseback**.

If none of the finance lease criteria are satisfied, **the seller-lessee accounts for the transaction as a sale and the lease as an operating lease**. Under an operating lease, as long as the sale-leaseback transaction is established at fair value, any gain or loss is recognized immediately.⁹

Lessor

If the lease meets one of the lease capitalization criteria, the **purchaser-lessor** records the transaction as a purchase and a direct-financing lease. If the lease does not meet the criteria, the purchaser-lessor records the transaction as a purchase and an operating lease.

Sale-Leaseback Example

To illustrate the accounting treatment accorded a sale-leaseback transaction, assume that **Japan Airlines (JAL)** (JPN) on January 1, 2012, sells a used Boeing 757 having a carrying amount on its books of \$75,500,000 to **CitiCapital** (USA) for \$80,000,000. JAL immediately leases the aircraft back under the following conditions:

1. The term of the lease is 15 years, non-cancelable, and requires equal rental payments of \$10,487,443 at the beginning of each year.
2. The aircraft has a fair value of \$80,000,000 on January 1, 2012, and an estimated economic life of 15 years.
3. JAL pays all executory costs.
4. JAL depreciates similar aircraft that it owns on a straight-line basis over 15 years.
5. The annual payments assure the lessor a 12 percent return.
6. JAL knows the implicit rate.

⁸Sales and leasebacks of real estate are often accounted for differently. A discussion of the issues related to these transactions is beyond the scope of this textbook.

⁹If the sales price is not at fair value and the loss is compensated for by reduced future lease payments (below market rates), the loss shall be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used. If the sales price is above fair value, the excess over fair value shall be deferred and amortized over the period for which the asset is expected to be used. **[11]**

This lease is a finance lease to JAL because the lease term is equal to the estimated life of the aircraft and because the present value of the lease payments is equal to the fair value of the aircraft to CitiCapital. CitiCapital should classify this lease as a direct-financing lease.

Illustration 21-14 presents the typical journal entries to record the sale-leaseback transactions for JAL and CitiCapital for the first year.

ILLUSTRATION 21-14
Comparative Entries for
Sale-Leaseback for Lessee
and Lessor

	<u>JAL (Lessee)</u>		<u>CitiCapital (Lessor)</u>		
Sale of Aircraft by JAL to CitiCapital (January 1, 2012):					
Cash	80,000,000		Aircraft	80,000,000	
Aircraft		75,500,000	Cash	80,000,000	
Unearned Profit on Sale-Leaseback		4,500,000	Lease Receivable	80,000,000	
Leased Aircraft under Finance Leases	80,000,000		Aircraft	80,000,000	
Lease Liability		80,000,000			
First Lease Payment (January 1, 2012):					
Lease Liability	10,487,443		Cash	10,487,443	
Cash		10,487,443	Lease Receivable	10,487,443	
Incurrence and Payment of Executory Costs by JAL throughout 2012:					
Insurance, Maintenance, Taxes, etc.	XXX			(No entry)	
Cash or Accounts Payable		XXX			
Depreciation Expense on the Aircraft (December 31, 2012):					
Depreciation Expense	5,333,333			(No entry)	
Accumulated Depr.—Finance Leases (\$80,000,000 ÷ 15)		5,333,333			
Amortization of Profit on Sale-Leaseback by JAL (December 31, 2012):					
Unearned Profit on Sale-Leaseback	300,000			(No entry)	
Depreciation Expense (\$4,500,000 ÷ 15)		300,000			
Note: A case might be made for crediting Revenue instead of Depreciation Expense.					
Interest for 2012 (December 31, 2012):					
Interest Expense	8,341,507 ^a		Interest Receivable	8,341,507	
Interest Payable		8,341,507	Interest Revenue	8,341,507 ^a	
^a Partial Lease Amortization Schedule:					
	<u>Date</u>	<u>Annual Rental Payment</u>	<u>Interest 12%</u>	<u>Reduction of Balance</u>	<u>Balance</u>
	1/1/12				\$80,000,000
	1/1/12	\$10,487,443	\$ —0—	\$10,487,443	69,512,557
	1/1/13	10,487,443	8,341,507	2,145,936	67,366,621

AUTHORITATIVE LITERATURE

Authoritative Literature References

- [1] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 10.
- [2] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), paras. 10(e) and 11.

- [3] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 11.
- [4] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 4.
- [5] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 11(b).
- [6] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 20.
- [7] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 4.
- [8] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), paras. 31 and 35.
- [9] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), paras. 47 and 56.
- [10] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 59.
- [11] International Accounting Standard 17, *Leases* (London, U.K.: International Accounting Standards Committee Foundation, 2003), par. 61.

QUESTIONS

- | | |
|--|---|
| <ul style="list-style-type: none"> 1. Outline the accounting procedures involved in applying the operating method by a lessee. 2. Outline the accounting procedures involved in applying the finance lease method by a lessee. | <ul style="list-style-type: none"> 3. Identify the lease classifications for lessors and the criteria that must be met for each classification. 4. What disclosures should be made by lessees and lessors related to future lease payments? |
|--|---|

BRIEF EXERCISES

BE21-1 Rick Kleckner Corporation recorded a finance lease at \$300,000 on January 1, 2011. The interest rate is 12%. Kleckner Corporation made the first lease payment of \$53,920 on January 1, 2011. The lease requires eight annual payments. The equipment has a useful life of 8 years with no residual value. Prepare Kleckner Corporation's December 31, 2011, adjusting entries.

BE21-2 Use the information for Rick Kleckner Corporation from BE21-1. Assume that at December 31, 2011, Kleckner made an adjusting entry to accrue interest expense of \$29,530 on the lease. Prepare Kleckner's January 1, 2012, journal entry to record the second lease payment of \$53,920.

BE21-3 Assume that **Lenovo** (CHN) leased equipment that was carried at a cost of \$150,000 to Sharon Swander Company. The term of the lease is 6 years beginning January 1, 2011, with equal rental payments of \$30,044 at the beginning of each year. All executory costs are paid by Swander directly to third parties. The fair value of the equipment at the inception of the lease is \$150,000. The equipment has a useful life of 6 years with no residual value. The lease has an implicit interest rate of 8%, no bargain-purchase option, and no transfer of title. Prepare Lenovo's January 1, 2011, journal entries at the inception of the lease.

BE21-4 Use the information for Lenovo from BE21-3. Assume the direct-financing lease was recorded at a present value of \$150,000. Prepare Lenovo's December 31, 2011, entry to record interest.

BE21-5 On January 1, 2011, Iniesta Animation sold a truck to Robben Finance for €33,000 and immediately leased it back. The truck was carried on Iniesta's books at €28,000. The term of the lease is 5 years, and title transfers to Iniesta at lease-end. The lease requires five equal rental payments of €8,705 at the end of each year. The appropriate rate of interest is 10%, and the truck has a useful life of 5 years with no residual value. Prepare Iniesta's 2011 journal entries.

EXERCISES

E21-1 (Lessee Computations and Entries, Finance Lease with Guaranteed Residual Value) Brecker Company leases an automobile with a fair value of €10,906 from Emporia Motors, Inc., on the following terms:

1. Non-cancelable term of 50 months.
2. Rental of €250 per month (at end of each month). (The present value at 1% per month is €9,800.)
3. Estimated residual value after 50 months is €1,180. (The present value at 1% per month is €715.) Brecker Company guarantees the residual value of €1,180.
4. Estimated economic life of the automobile is 60 months.
5. Brecker Company's incremental borrowing rate is 12% a year (1% a month). It is impracticable to determine Emporia's implicit rate.

Instructions

- (a) What is the nature of this lease to Brecker Company?
- (b) What is the present value of the minimum lease payments?
- (c) Record the lease on Brecker Company's books at the date of inception.
- (d) Record the first month's depreciation on Brecker Company's books (assume straight-line).
- (e) Record the first month's lease payment.

E21-2 (Lessee Entries with Bargain-Purchase Option) The following facts pertain to a non-cancelable lease agreement between Lennox Leasing Company and Gill Company, a lessee.

Inception date:	May 1, 2010
Annual lease payment due at the beginning of each year, beginning with May 1, 2010	€18,829.49
Bargain-purchase option price at end of lease term	€ 4,000.00
Lease term	5 years
Economic life of leased equipment	10 years
Lessor's cost	€65,000.00
Fair value of asset at May 1, 2010	€81,000.00
Lessor's implicit rate	10%
Lessee's incremental borrowing rate	10%

The lessee assumes responsibility for all executory costs.

Instructions

(Round all numbers to the nearest cent.)

- (a) Discuss the nature of this lease to Gill Company.
- (b) Discuss the nature of this lease to Lennox Company.
- (c) Prepare a lease amortization schedule for Gill Company for the 5-year lease term.
- (d) Prepare the journal entries on the lessee's books to reflect the signing of the lease agreement and to record the payments and expenses related to this lease for the years 2010 and 2011. Gill's annual accounting period ends on December 31. Reversing entries are used by Gill.

E21-3 (Lessor Entries with Bargain-Purchase Option) A lease agreement between Lennox Leasing Company and Gill Company is described in E21-2.

Instructions

Refer to the data in E21-8 and do the following for the lessor. (Round all numbers to the nearest cent.)

- (a) Compute the amount of the lease receivable at the inception of the lease.
- (b) Prepare a lease amortization schedule for Lennox Leasing Company for the 5-year lease term.
- (c) Prepare the journal entries to reflect the signing of the lease agreement and to record the receipts and income related to this lease for the years 2010, 2011, and 2012. The lessor's accounting period ends on December 31. Reversing entries are not used by Lennox.

E21-4 (Sale-Leaseback) Assume that on January 1, 2011, Peking Duck Co. sells a computer system to Liquidity Finance Co. for ¥510,000 and immediately leases the computer system back. The relevant information is as follows.

1. The computer was carried on Peking's books at a value of ¥450,000.
2. The term of the non-cancelable lease is 10 years; title will transfer to Peking.
3. The lease agreement requires equal rental payments of ¥83,000.11 at the end of each year.
4. The incremental borrowing rate for Peking is 12%. Peking is aware that Liquidity Finance Co. set the annual rental to ensure a rate of return of 10%.

5. The computer has a fair value of ¥510,000 on January 1, 2011, and an estimated economic life of 10 years.
6. Peking pays executory costs of ¥9,000 per year.

Instructions

Prepare the journal entries for both the lessee and the lessor for 2011 to reflect the sale-leaseback agreement.

PROBLEMS


P21-1 (Statement of Financial Position and Income Statement Disclosure—Lessee) The following facts pertain to a non-cancelable lease agreement between Alschuler Leasing Company and McKee Electronics, a lessee, for a computer system.

Inception date	October 1, 2010
Lease term	6 years
Economic life of leased equipment	6 years
Fair value of asset at October 1, 2010	£300,383
Residual value at end of lease term	–0–
Lessor's implicit rate	10%
Lessee's incremental borrowing rate	10%
Annual lease payment due at the beginning of each year, beginning with October 1, 2010	£62,700

The lessee assumes responsibility for all executory costs, which amount to £5,500 per year and are to be paid each October 1, beginning October 1, 2010. (This £5,500 is not included in the rental payment of £62,700.) The asset will revert to the lessor at the end of the lease term. The straight-line depreciation method is used for all equipment.

The following amortization schedule has been prepared correctly for use by both the lessor and the lessee in accounting for this lease. The lease is to be accounted for properly as a finance lease by the lessee and as a direct-financing lease by the lessor.

Date	Annual Lease Payment/ Receipt	Interest (10%) on Unpaid Liability/Receivable	Reduction of Lease Liability/Receivable	Balance of Lease Liability/Receivable
10/01/10				£300,383
10/01/10	£ 62,700		£ 62,700	237,683
10/01/11	62,700	£23,768	38,932	198,751
10/01/12	62,700	19,875	42,825	155,926
10/01/13	62,700	15,593	47,107	108,819
10/01/14	62,700	10,822	51,818	57,001
10/01/15	62,700	5,699*	57,001	–0–
	£376,200	£75,817	£300,383	

*Rounding error is £1.

Instructions

(Round all numbers to the nearest cent.)

- (a) Assuming the lessee's accounting period ends on September 30, answer the following questions with respect to this lease agreement.
 - (1) What items and amounts will appear on the lessee's income statement for the year ending September 30, 2011?
 - (2) What items and amounts will appear on the lessee's statement of financial position at September 30, 2011?
 - (3) What items and amounts will appear on the lessee's income statement for the year ending September 30, 2012?

- (4) What items and amounts will appear on the lessee's statement of financial position at September 30, 2012?
- (b) Assuming the lessee's accounting period ends on December 31, answer the following questions with respect to this lease agreement.
- (1) What items and amounts will appear on the lessee's income statement for the year ending December 31, 2010?
 - (2) What items and amounts will appear on the lessee's statement of financial position at December 31, 2010?
 - (3) What items and amounts will appear on the lessee's income statement for the year ending December 31, 2011?
 - (4) What items and amounts will appear on the lessee's statement of financial position at December 31, 2011?



P21-2 (Statement of Financial Position and Income Statement Disclosure—Lessor) Assume the same information as in P21-1.

Instructions

(Round all numbers to the nearest cent.)

- (a) Assuming the lessor's accounting period ends on September 30, answer the following questions with respect to this lease agreement.
- (1) What items and amounts will appear on the lessor's income statement for the year ending September 30, 2011?
 - (2) What items and amounts will appear on the lessor's statement of financial position at September 30, 2011?
 - (3) What items and amounts will appear on the lessor's income statement for the year ending September 30, 2012?
 - (4) What items and amounts will appear on the lessor's statement of financial position at September 30, 2012?
- (b) Assuming the lessor's accounting period ends on December 31, answer the following questions with respect to this lease agreement.
- (1) What items and amounts will appear on the lessor's income statement for the year ending December 31, 2010?
 - (2) What items and amounts will appear on the lessor's statement of financial position at December 31, 2010?
 - (3) What items and amounts will appear on the lessor's income statement for the year ending December 31, 2011?
 - (4) What items and amounts will appear on the lessor's statement of financial position at December 31, 2011?

USING YOUR JUDGMENT

FINANCIAL REPORTING

Financial Reporting Problem

Marks and Spencer plc (M&S)

The financial statements of **M&S** can be accessed at the book's companion website, www.wiley.com/college/kiesoifrs.

Instructions

Refer to M&S's financial statements and the accompanying notes to answer the following questions.

- (a) What types of leases are used by M&S?
- (b) What amount of finance leases was reported by M&S in total and for less than one year?
- (c) What minimum annual rental commitments under all non-cancelable leases at March 29, 2008, did M&S disclose?



Financial Statement Analysis Case

Delhaize Group

Presented in Illustration 21-12 are the financial statement disclosures from the 2008 annual report of **Delhaize Group** (BEL).

Instructions

Answer the following questions related to these disclosures.

- (a) What is the total obligation under finance leases at year-end 2008 for Delhaize?
- (b) What is the total rental expense reported for leasing activity for the year ended December 31, 2008, for Delhaize?
- (c) Estimate the off-balance-sheet liability due to Delhaize operating leases at fiscal year-end 2008.

IFRS

BRIDGE TO THE PROFESSION

Professional Research

Daniel Hardware Co. is considering alternative financing arrangements for equipment used in its warehouses. Besides purchasing the equipment outright, Daniel is also considering a lease. Accounting for the outright purchase is fairly straightforward, but because Daniel has not used equipment leases in the past, the accounting staff is less informed about the specific accounting rules for leases.

The staff is aware of some general lease rules related to “risks and rewards,” but they are unsure about the meanings of these terms in lease accounting. Daniel has asked you to conduct some research on these items related to lease capitalization criteria.

Instructions

Access the IFRS authoritative literature at the IASB website (<http://eifrs.iasb.org/>). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

- (a) What is the objective of lease classification criteria?
- (b) An important element of evaluating leases is determining whether substantially all of the risks and rewards of ownership are transferred in the lease. How is “substantially all” defined in the authoritative literature?
- (c) Besides the non-cancelable term of the lease, name at least three other considerations in determining the “lease term.”