Leases (IAS 17)

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Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. Lessees' Financial Statements
4. Lessors' Financial Statements
5. Sale and Leaseback Transactions
6. Transitional Provisions
7. Implementation Issues

1. Objective and Scope

- The objective of IAS 17 *Leases*
  - is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.
- A lease
  - is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments *the right to use an asset* for an agreed period of time.

1. Objective and Scope

- IAS 17 shall be applied in accounting for all leases other than:
  a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
  b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
- IAS 17 shall not be applied as the basis of measurement for:
  a) property held by lessees that is accounted for as investment property (see IAS 40),
  b) investment property provided by lessors under operating leases (see IAS 40),
  c) biological assets held by lessees under finance leases (see IAS 41), or
  d) biological assets provided by lessors under operating leases (see IAS 41).

1. Objective and Scope

- IAS 17 Leases
  - Applies to agreements that transfer the right to use assets
    - even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.
  - But does not apply to agreements that are contracts for services that
    - do not transfer the right to use assets from one contracting party to the other.

Today's Agenda

1. Objective and Scope
2. **Classification of Leases**
   - **Classification of Land and Buildings**

2. Classification of Leases

The classification of leases adopted in IAS 17

- Is based on the extent to which risks and rewards incidental to ownership of a leased asset lie the the lessor or the leseee.

Risks and Rewards

Finance Lease

- A finance lease
  - is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.
  - Title may or may not eventually be transferred.

Operating Lease

- An operating lease
  - is a lease other than a finance lease

2. Classification of Leases

Risks include the possibilities of losses

- from idle capacity or technological obsolescence and
- of variations in return because of changing economic conditions.

Rewards may be represented by the expectation of

- of profitable operation over the asset's economic life and
- of gain from appreciation in value or realisation of a residual value.

Risks and Rewards

Finance Lease

- A lease is classified as a finance lease
  - if it transfers substantially all the risks and rewards incidental to ownership.

Operating Lease

- A lease is classified as an operating lease
  - if it does not transfer substantially all the risks and rewards incidental to ownership.

2. Classification of Leases

Case

中国石油天然气股份有限公司
PetroChina Company Limited

Accounting policy on leases (annual report 2005):

- Leases of property, plant and equipment where the Group assumes substantially all the benefits and risks of ownership
  - are classified as finance leases.

中国銀行(香港)
BANK OF CHINA (HONG KONG)

Accounting policy on operating lease (annual report 2005):

- Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor
  - are classified as operating leases.

2. Classification of Leases

Case

GALAXY 银河

Galaxy Entertainment Group Limited (2005 Annual Report)

- Leases that substantially transfer to the Group all the risks and rewards of ownership of assets
  - are accounted for as finance leases.
- Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor
  - are classified as operating leases.

2. Classification of Leases

Example

Is a hire purchase contract a lease?

- The definition of a lease includes
  - contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions.
  - These contracts are sometimes known as hire purchase contracts.

Finance Lease

Operating Lease

Is a hire purchase contract classified as a finance lease or an operating lease?

2. Classification of Leases

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
- Indicators of a finance lease include:

Finance Lease

a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

Operating Lease

d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

2. Classification of Leases

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
- Indicators of a finance lease include:

What is
- Lease term? Economic life?
- Inception of a lease?
- Minimum lease payment ……

Finance Lease

Major part?

c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

Operating Lease

d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

Substantially all?

2. Classification of Leases

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
- Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
  a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
  b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
  c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Finance Lease

Operating Lease

2. Classification of Leases

Lease classification is made at the inception of the lease.

Finance Lease

Operating Lease

What is "inception of the lease"?

- The inception of the lease is the earlier of
  - the date of the lease agreement and
  - the date of commitment by the parties to the principal provisions of the lease.
- As at this date:
  a) a lease is classified as either or a finance or an operating lease; and
  b) in the case of a finance lease,
     - the amounts to be recognised at the commencement of the lease term are determined.

2. Classification of Leases

Finance Lease

Operating Lease

The lease term is
- the non-cancellable period for which the lessee has contracted to lease the asset
- together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

The commencement of the lease term
- is the date from which the lessee is entitled to exercise its right to use the leased asset.
- It is the date of initial recognition of the lease (i.e. the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

2. Classification of Leases

Example

Determine the lease term of the following leases:

1. A lease with 2-year initial term and another 2-year further term. The lessor has an option to cancel the further term.

   Lease term: 2 years
   - The lessee has no discretionary right to renew

2. A lease with 2-year initial term. The lessee has the right to extend 2-year further term but he had not decided to take this term at the inception of the lease.

   Lease term: 2 years
   - It is <u>not reasonably certain</u> that the lessee will exercise the option

3. A lease with the same term as the above term but the lessee has decided to take the further term at the inception of the lease.

   Lease term: 4 years
   - It is <u>reasonably certain</u> that the lessee will exercise the option

2. Classification of Leases

Finance Lease

Operating Lease

Minimum lease payments are
- the <u>payments over the lease term</u> that the lessee is or can be required to make, <u>excluding</u>
  - <u>contingent rent</u>,
  - costs for services and
  - taxes to be paid by and reimbursed to the lessor,
- together with:
  a) for a lessee, any <u>amounts guaranteed by the lessee</u> or by a party related to the lessee; or
  b) for a lessor, <u>any residual value guaranteed to the lessor</u> 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.

2. Classification of Leases

Example

- Determine the minimum lease payment (MLP) of the following lease to the lessee and the lessor:
  - AJS Ltd. has a 5-year lease to rent its office with an annual payment of $10,000.
  - It makes a guarantee to the lessor, C & P Inc., that the office should have a value not less than $10,000.
  - It's parent, AJS Holding Inc., also makes a further guarantee of $10,000
  - C & P Inc. in turn has obtained an additional guarantee of $5,000 from the property agent.

For the lessee, AJS Ltd., the MLP is:

– Payments over the lease term $10,000 × 5	$50,000
– Guarantee (incl. the one from parent) $10,000 + $10,000	20,000
	$70,000

For the lessor, C& P, the MLP is:

– MPL as above	$70,000
– Guarantee from agent	5,000
	$75,000

2. Classification of Leases

- Lease with provision to adjust lease payments
  - the effect of any such changes shall be deemed to have taken place at the inception of the lease for the purposes of IAS 17.
- Change of provision of a lease, other than by renewing the lease
  - in a manner that would have resulted in a different classification of the lease, the revised agreement is regarded as a new agreement over its term.

Finance Lease

Operating Lease

2. Classification of Leases

Example

- Shall we determine the classification of a lease once again when there are
  - Changes in estimates of the economic life of the leased asset
  - Changes in estimates of the residual value of the leased property, or
  - Default by the lessee,?

- Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee),
  - do not give rise to a new classification of a lease for accounting purposes.

2. Classification of Leases

Example

- Fat Choy has financed its business expansion by acquiring new production plant and equipment through utilising certain leasing arrangements during the year.
- The leases
  - include options enabling Fat Choy to purchase the assets at their fair values at the end of the lease term.
  - will last for five years, which is also the expected useful life of the assets.
  - Give Fat Choy the right to cancel the leases, and the lessor's losses associated with the cancellation will be borne by Fat Choy.
- For simplicity, Fat Choy would like to record these acquisitions off the balance sheet and charge all leasing charges to income.
- Discuss the appropriate accounting treatment.

(Source from HKICPA)

2. Classification of Leases

Example

- Fat Choy has financed its business expansion by acquiring new production plant and equipment through utilising certain leasing arrangements during the year.
- The leases
  - include options enabling Fat Choy to purchase the assets at their fair values at the end of the lease term. — Indicator of finance lease?
  - will last for five years, which is also the expected useful life of the assets. — √ Indicator of finance lease?
  - Give Fat Choy the right to cancel the leases, and the lessor's losses associated with the cancellation will be borne by Fat Choy. — √ Indicator of finance lease?
- For simplicity, Fat Choy would like to record these acquisitions off the balance sheet and charge all leasing charges to income.
- Discuss the appropriate accounting treatment.

(Source from HKICPA)

2. Classification of Leases

Answers

- It is commonly agreed that the economic reality of leasing requires that some long-term leases be accounted for as capital acquisitions by the lessee and sales by the lessor.
- IAS 17 identified criteria to determine whether a lease is merely a rental contract (operating lease) or is, in substance, a purchase of property (a finance lease).
- IAS 17 defines a finance lease as "a lease that transfers substantially all the risks and rewards incident to ownership of an asset." Thus, an operating lease is a lease other than a finance lease.
- The classification of leases adopted in IAS 17 is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee.
- Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.
- Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

2. Classification of Leases

Answers

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations which would normally lead to a lease being classified as a finance lease include:
  1. the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

     In this case, the leases include options enabling Fat Choy to purchase the assets at their fair values at the end of the lease term.

     Since Fat Choy has to purchase the assets at their fair values, it is not certain that the option will be exercised.
  2. the lease term is for the major part of the economic life of the asset even if title is not transferred.

     In this case, the leases will last for five years, which is also the expected useful life of the assets.

2. Classification of Leases

Answers

- Although Fat Choy is given the right to cancel the leases, the lessor's losses associated with the cancellation will be borne by Fat Choy.
- This is indeed one of the IAS17's indicators of situations which individually or in combination could lead to a lease being classified as a finance lease.
- As a finance lease, lease payments should be apportioned between the finance charge and the reduction of the outstanding liability.
- The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.
- As a result, Fat Choy cannot charge all leasing charges to income since the leases are classified as finance leases rather than operating leases.

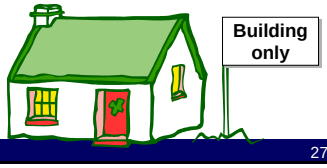
2. Classification – Lease of L&B

Lease of land

Lease of land and buildings

- Lease of land and of buildings are classified as operating or finance leases
  - in the same way as leases of other assets
  - but ……

Critical change and problematic



Building only

Land only

2. Classification – Lease of Land

Lease of land

- Lease of land is classified in the same way as leases of other assets
- However, as land normally has an indefinite economic life
- If title of leasehold land is not expected to pass to the lessee
  - ⇒ Lessee normally does not receive substantially all of the risks and rewards incidental to the ownership
  - ⇒ In which case the lease of land will be an **operating lease**
    - payment acquiring such leasehold represents **prepaid lease payments**
    - amortised over the lease term in accordance with the pattern of benefits provided

Land only → Leasehold land without title pass → **Operating Lease**

2. Classification – Lease of Land

Case

中国电信 CHINA TELECOM

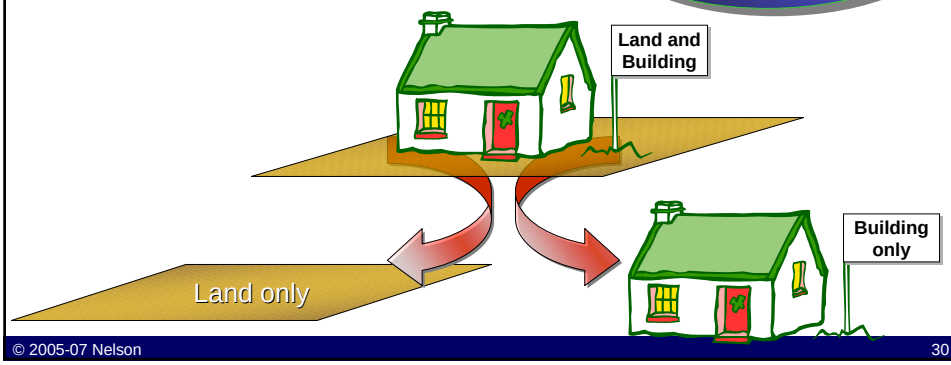
Annual Report 2005

- Accounting policy on lease prepayments
  - Lease prepayments represent land use rights paid to the PRC's land bureau.
  - Land use rights are carried at cost less accumulated amortisation and impairment losses.
  - Amortisation is provided to write off the cost of lease prepayments on a straight-line basis over the respective periods of the rights which range from 20 years to 70 years.

2. Classification – Lease of L&B

Lease of land → Lease of land and buildings

Separate measurement
(of the land and buildings elements)



2. Classification – Lease of L&B

Lease of land and buildings

If a lease contains land and buildings elements

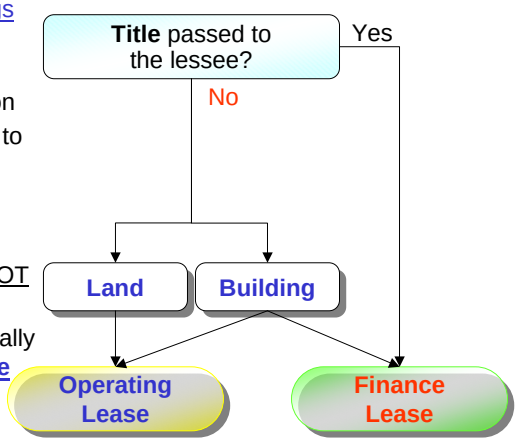
- 2 elements are considered separately for lease classification

If **title** of both elements is expected to pass to the lessee

- Both elements are classified as **finance lease**

If **title** of land or both elements is NOT expected to pass to the lessee

- The land element alone is normally classified as an **operating lease**
- The building element is considered separately

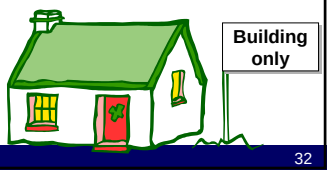


2. Classification – Lease of L&B

Lease of land and buildings

- To classify and account for a lease of land and buildings
  - the minimum lease payments (including any lump-sum upfront payments) are allocated between
    - the land and
    - the buildings elements
  - in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease

Relative Fair Value



2. Classification – Lease of L&B

Case

"The early adoption of HKAS 17 (same as IAS 17) has resulted in a change in accounting policy relating to leasehold land."

"Leasehold land and buildings were previously carried at valuation less accumulated depreciation."

"In accordance with the provisions of HKAS 17, a lease of land and building should be split into a lease of land and a lease of building in proportion to the relative fair values of the leasehold interests in the land element and the building element of the lease at the inception of the lease."

"The *lease premium for land* is stated *at cost* and *amortised* over the period of the lease whereas the *leasehold building* is stated at *valuation* less accumulated depreciation."

2004 Annual Report, HKEX

香港交易所 HKEx

2. Classification – Lease of L&B

Case

Effect of adopting HKAS 17 Leases	Increase/(Decrease)
Balance sheet as at 31 December 2004	HK$'000
Fixed assets	(170,100)
Lease premium for land	95,218
Deferred tax liabilities	(19,139)
Revaluation reserves	(73,815)
Retained earnings	18,072
Income statement for the year 2004	
Increase in premises expenses	548
Decrease in depreciation	(1,749)
Increase in taxation	128

2004 Annual Report, HKEX

香港交易所 HKEx

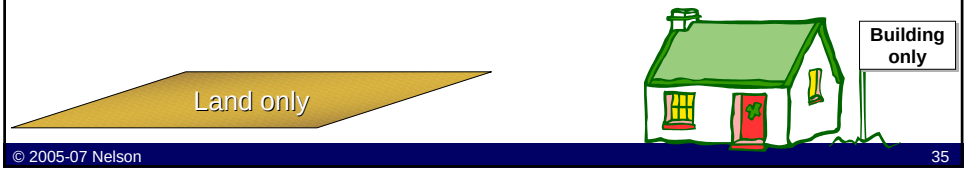
From valuation to cost (for land)

- **Non-current assets reduced by HK$ 75 million**

2. Classification – Lease of L&B

Lease of land and buildings

- If the lease payments cannot be allocated reliably between the 2 elements
  - the entire lease is classified as a **finance lease**
  - unless it is clear that both elements are operating leases, in which case the entire lease is classified as an **operating lease**
- For a lease of land and building if the land is immaterial
  - The lease may be treated as a single unit and classified as finance or operating leases



2. Classification – Lease of L&B

Case

Melco Development Limited (2005 Annual Report)

In previous years,

- owner-occupied leasehold land and buildings were included in property, plant and equipment and measured using the cost model.

In the current year,

- the Group has applied HKAS 17 *Leases*.
- Under HKAS 17, the land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification, unless the lease payments cannot be allocated reliably between the land and buildings elements, in which case, the entire lease is generally treated as a finance lease.
- To the extent that the allocation of the lease payments between the land and buildings elements can be made reliably, the leasehold interests in land are reclassified to prepaid lease payments under operating leases, which are carried at cost and amortised over the lease term on a straight-line basis.

2. Classification – Lease of L&B

Case

中國銀行(香港)
BANK OF CHINA (HONG KONG)

Accounting policy on finance lease on properties (annual report 2005):

- On adoption of the deemed cost at the date of Merger (2001), the Group made reference to the independent property valuation conducted as at 31 Aug. 2001 for the purpose of the Merger, which did not split the values of the leasehold properties between the land and buildings elements.
- Any means of subsequent allocation of the valuation of the leasehold properties at the date of Merger between the land and buildings elements would be notional and therefore would not represent reliable information.
- It is determined that the values of the land and buildings elements of the Group's leasehold properties cannot be reliably split and the leasehold properties are treated as finance leases.
- The Group has also adopted the revaluation model under HKAS 16 by which assets held for own use arising under these finance leases are measured at fair value less any accumulated depreciation and impairment losses.

2. Classification – Lease of L&B

Case

交通銀行
BANK OF COMMUNICATIONS

Accounting policy on land use right (annual report 2005):

- Land use rights are recognised initially at 'cost',
  - being the consideration paid for the rights to use and occupy the land.
- Land use rights are amortised
  - using the straight-line method to write off the cost over their estimated useful lives of 30 to 70 years.
- Land use rights are not separately presented from building, when
  - they are acquired together with the building at inception and
  - the costs attributable to the land use rights cannot be reasonably measured and separated from that of the building.

2. Classification – Lease of L&B

Case

方正控股有限公司 Founder Holdings Limited

Annual Report 2005

- In the opinion of the directors, the lease payments of the Group cannot be allocated reliably between the land and building elements, therefore, the entire lease payments are included in the cost of land and building and are amortised over the shorter of the lease terms and useful lives.

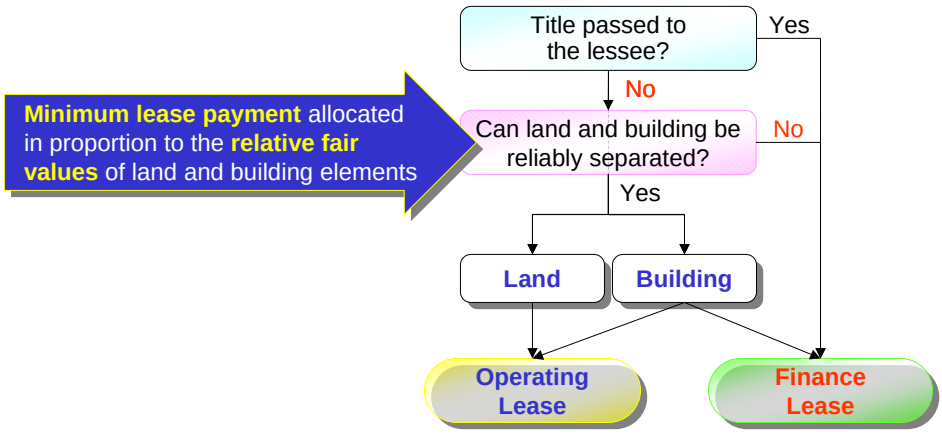
taifook大福 securities group 證券集團

Annual Report 2005

- As the Group's lease payments cannot be allocated reliably between the land and buildings elements, the entire lease payments are included in the cost of the land and buildings as a finance lease in property, plant and equipment.
- The adoption of HKAS 17 has not resulted in any change in the measurement of the Group's land and buildings.

2. Classification – Lease of L&B

Lease of land and buildings



2. Classification – Lease of L&B

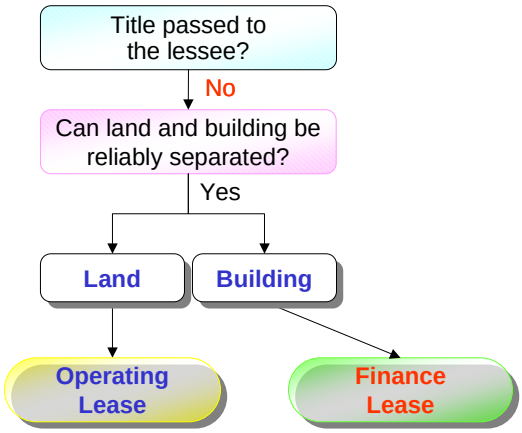
Example

Lease of land and buildings

Entity A

- paid a land premium to lease a land from the government for 50 years

- then, constructed a building on the land for own use



2. Classification – Lease of L&B

Example

Entity A

- paid a land premium to lease a land from the government for 50 years

Land premium
- assumed to be the fair value of the land and accounted for as an operating lease under IAS 17
- amortised over 50 years
- disclosed separately from the building cost as a non-current asset

- then, constructed a building on the land for own use

Building cost
- accounted for as property, plant and equipment under IAS 16
- carried in accordance with the accounting policies adopted for that class of assets (either cost model or revaluation model)

2. Classification – Lease of L&B

Example

Entity A

- paid a land premium to lease a land from the government for 50 years

- then, constructed a building on the land for own use

10 years later, Entity B "acquired" the interest of the land and building for own use

At the inception of the lease (of Entity B)

- allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease

If NO recent transaction for a similar land

- It may be impossible to reliably identify the relative fair value of the land
- Whole lease → as a finance lease

If there is recent transaction for a similar land

- The relative fair value of the land and building may be reliably identified
- Land → as operating lease under IAS 17
- Building → as PPE under IAS 16

2. Classification – Lease of L&B

Example

Entity A

- paid a land premium to lease a land from the government for 50 years

- then, constructed a building on the land for own use

10 years later, Entity B "acquired" the interest of the land and building for own use

Assuming Entity B "acquired" the property at $20 million and

- A similar land has a fair value of $12M
- Construction cost of a similar building is $4M

- $ 20M to be separated in proportion to the relative fair values of the land and building element at the inception of the lease, i.e. by $ 12M to $ 4M
- Then, the separate measurement will result in:

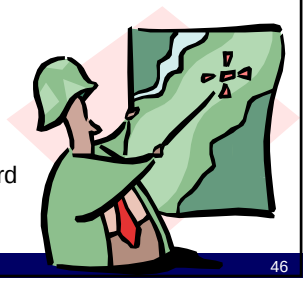
Land	= $	15M	($20M × $12M / $16M)
Building	= $	5M	($20M × $ 4M / $16M)

2. Classification – Separation Waived

- Exemption from separation measurement of land and building if:
  - the leasehold land and buildings is classified as an investment property (if fulfils IAS 40), and
  - the fair value model is adopted.

2. Classification – Separation Waived

- Exemption from separation measurement of land and building
- Such property interest so classified even under an operating lease
  - is accounted for as if it were a finance lease
  - the fair value model is used
- In addition, such lease shall still be accounted for as a finance lease continuously, even if a subsequent event changes the nature of the lessee's property interest so that it is no longer classified as investment property, examples include
  - transferred from investment property to owner-occupied property (at a deemed cost equal to its fair value at the date of change in use); or
  - grants a finance lease (sublease) to an unrelated third party.



Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. **Lessees' Financial Statements**

Finance Lease

Operating Lease

After a proper classification is made from the lessee's view ……

3. Lessees' Financial Statements

Initial Recognition and Measurement

Finance Lease

- At lease commencement, lessees shall recognise finance leases as *assets* and *liabilities* in their balance sheets at amounts equal to
  a) the fair value of the leased property, or
  b) if lower, the present value of the minimum lease payments,

  each determined at the inception of the lease.

  – The discount rate to be used in calculating the present value of the minimum lease payments is
    - the interest rate implicit in the lease, if this is practicable to determine;
    - if not, the lessee's incremental borrowing rate shall be used.
  – Any initial direct costs of the lessee are added to the amount recognised as an asset.

3. Lessees' Financial Statements

Subsequent Measurement

Finance Lease

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

- Contingent rent is that portion of the lease payments
  - that is not fixed in amount
  - but is based on the future amount of a factor that changes other than with the passage of time

    e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest

3. Lessees' Financial Statements

Subsequent Measurement

Finance Lease

- A finance lease gives rise to
  - depreciation expense for depreciable assets as well as
  - finance expense for each accounting period
- The depreciation policy for depreciable leased assets
  - consistent with that for depreciable assets that are owned, and
  - the depreciation recognised shall be calculated in accordance with IAS 16 and IAS 38
- If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term
  - the asset shall be fully depreciated over the shorter of
    - the lease term and
    - its useful life

3. Lessees' Financial Statements

Case

Melco Development Limited (2005 Annual Report)

Accounting policies

- Assets held under finance leases are recognised as assets of the Group
  - at their fair value at the inception of the lease or,
  - if lower, at the present value of the minimum lease payments.
- The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation.
- Lease payments are apportioned between
  - finance charges and
  - reduction of the lease obligation

  so as to achieve a constant rate of interest on the remaining balance of the liability.
- Finance charges are charged directly to profit or loss.

3. Lessees' Financial Statements

Disclosures

- In addition to meeting the requirements of IAS 32, the following disclosures for finance leases:
  a) for each class of asset, the net carrying amount at the balance sheet date.
  b) a reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
     i) not later than one year;
     ii) later than one year and not later than five years;
     iii) later than five years.
  c) contingent rents recognised as an expense in the period.
  d) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date.
  e) a general description of the lessee's material leasing arrangements.

Finance Lease

3. Lessees' Financial Statements

Case

Melco Development Limited (2005 Annual Report)

Note 45 – Obligation under Finance Lease

- It is the Group's policy to lease certain of its furniture, fixtures and equipment under finance leases.
- The average lease term is five years.
- Interest rates underlying all obligation under finance leases are fixed at respective contract dates at 8% (2004: 3%).
- All leases are on a fixed repayment basis and no arrangements have been entered into for contingent rental payments. *(Figures in next slides)*
- The Group's obligations under finance leases are secured by the lessor's charge over the leased assets.
- All finance lease obligations are denominated in Hong Kong dollars, the functional currency of the Group's entity which enters into the lease transaction.
- The directors consider that the carrying amount of the obligation under finance leases approximates their fair value.

3. Lessees' Financial Statements

Case

	Minimum lease payments		Present value of minimum lease payments	
	2005	2004	2005	2004
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*
Amounts payable under finance leases:				
Within one year	28	837	21	817
In more than one year but not more two years	28	–	21	–
In more than two years but not more three years	28	–	21	–
In more than three years but not more than four year	28	–	21	–
In more than four years but not more than five year	1	–	–	–
	113	837	84	817
Less: future finance charges	(29)	(20)	–	–
Present value of lease obligations	84	817	84	817
Less: Amount due within one year shown under current liabilities			(21)	(817)
			63	–

3. Lessees' Financial Statements

Example

- CPL has estimated that
  - a machine with a market value of $5 million will be required, and
  - it is expected to have a resale value of $1 million.
  - this represents a fair estimate of the market value of the machine at the end of the project's 5-year life.
  - this machine is popular in Taiwan and it has a normal useful life of 6 years.
- Alternatively, CPL could lease the machine
  - for 5 equal annual payments of $1,050,000 commencing immediately and payable at the beginning of each year.
  - The machine has to be returned to the lessor at the end of the lease period.
- Discuss the proper accounting treatment for the lease (by assuming implicit interest rate at 10%).

(Source from HKICPA)

3. Lessees' Financial Statements

Answers

- The accounting treatment of leases has significant impact on the balance sheet.
- With only minimal disclosure, leasing used to be attractive to certain firms as an "off-balance sheet" method of financing.
- Then came the IAS 17 with an explicit ruling that called for the capitalisation on the balance sheet of certain types of leases.
- In essence, IAS 17 says that if the lessee acquires substantially all of the risks and benefits associated with the leased asset, then the value of the asset, along with the corresponding lease obligation, must be shown on the balance sheet.
- Leases that conform in principle to this definition are called finance leases.
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

3. Lessees' Financial Statements

Answers

- Examples of situations, which would normally lead to a lease being classified as a finance lease, are:
  a) the lease transfers ownership of the asset to the lessee by the end of the lease term. This transfer of ownership is not found in this case.
  b) the lessee has the option to purchase the asset at a price, which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable. This option to purchase is not found in this case.
  c) the lease term is for the major part of the economic life of the asset even if title is not transferred. In this case, the lease term is 5 years, which is about 83% of the total economic useful life (6 years). It is difficult for CPL to argue that the lease term is not for the major part of the economic life of the asset.
  d) at the inception of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. Then, we have to determine the present value of the minimum lease payments (in the following slides).
  e) the leased assets are of a specialised nature such that only the lessee can use them without major modifications being made. As the machine is popular, this shows that it may not be of a specialised nature.

3. Lessees' Financial Statements

Answers

- Since CPL has not guaranteed any residual value, the present value of minimum lease payments:

  $1,050,000 x 4.1698 = $4,378,290

  where 4.1698 is the total of discount factor of 10% for 5 years.
- When compared to the fair value, 4,378,290 / 5,000,000 = 87.57%.
- Although it is slightly less than 90%, it still seems difficult for CPL to argue that the present value of the minimum lease payments does not amount to substantially all of the fair value of the leased asset.
- Since the lease term is for the major part (83%) of the economic life of the asset and the present value of the minimum lease payments amounts to a substantial portion of the fair value (87.57%) of the leased asset, it is difficult for CPL to argue that they have not acquired substantially all of the risks and benefits associated with the machine.
- Thus the value of the asset ($4,378,290) along with the corresponding lease obligation should be shown on the balance sheet.

3. Lessees' Financial Statements

Answers

- Lease payments ($1,050,000) should be apportioned between the finance charge and the reduction of the outstanding obligation.
- For example, at the end of year 1, $332,829 should be allocated to the finance charge and the balance ($717,171) should be regarded as the reduction of the outstanding obligation.

Year	Principal	Payment	Outstanding	10%	Balance c/f
1	4,378,290	1,050,000	3,328,290	332,829	3,661,119
2	3,661,119	1,050,000	2,611,119	261,112	2,872,231
3	2,872,231	1,050,000	1,822,231	182,223	2,004,454
4	2,004,454	1,050,000	954,454	95,546	1,050,000
5	1,050,000	1,050,000	0		0

3. Lessees' Financial Statements

Answers

- This finance lease will give rise to a depreciation expense for the asset as well as a finance expense for each accounting period.
- The depreciation policy for leased assets should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in IAS 16 "Property, plant and equipment".
- If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life,
  - thus a depreciation expense of $4,378,290 / 5 years = $875,658 will be recognised over the 5 years.

3. Lessees' Financial Statements

Case

中国石油天然气股份有限公司
PetroChina Company Limited

Accounting policy on leases (annual report 2005):

- Finance leases are capitalised at the inception of the lease at the lower of
  - the fair value of the leased property and
  - the estimated present value of the underlying lease payments.
- Each lease payment is allocated between
  - the liability and
  - finance charges

  so as to achieve a constant rate on the finance balance outstanding.
- Property, plant and equipment acquired under finance leases are generally depreciated over the useful life of the asset as the Group usually obtains ownership of such leased assets by the end of the leased term.

3. Lessees' Financial Statements

Case

MEDECINS SANS FRONTIERES
NOBEL PEACE PRIZE WINNER 1999

Medecins Sans Frontieres (International Financial Report 2004):

- Assets acquired under long-term finance leases are capitalized and recorded in the statement of financial position (i.e. balance sheet) as tangible fixed assets.
- They are depreciated over the shorter of their estimated useful life and the lease term.
- The associated obligations are included in financial debts.

3. Lessees' Financial Statements

Recognition (Initial and Subsequent)

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

Operating Lease

3. Lessees' Financial Statements

Disclosures

- Lessees shall, in addition to meeting the requirements of IAS 32, make the following disclosures for operating leases:
  a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
     i) not later than one year;
     ii) later than one year and not later than five years;
     iii) later than five years.
  b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date.
  c) lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.
  d) a general description of the lessee's significant leasing arrangements.

Operating Lease

3. Lessees' Financial Statements

Case

Melco Development Limited (2005 Annual Report)

53. OPERATING LEASES

(a) The Group as lessee

	THE GROUP 2005 HK$'000	2004 HK$'000
The Group made rental payment for properties under operating leases as follows:		
Minimum lease payments	20,279	9,342
Contingent rental payments	442	–
	20,721	9,342

At the balance sheet date, the Group had commitments for future minimum lease payments under non-cancellable operating leases which fall due as follows:

	THE GROUP 2005 HK$'000	2004 HK$'000
Within one year	29,418	19,620
In the second to fifth year inclusive	79,058	46,835
Over five years	39,036	–
	147,512	66,455

3. Lessees' Financial Statements

Case

Melco Development Limited (2005 Annual Report)

Note 53 – Operating leases (continued)

- The Group leases certain of its properties under operating lease arrangements.
- Leases for properties are negotiated for a term ranging from 3 to 10 years.
- In addition, the Group may pay additional rental expenses in respect of certain premises which are dependent upon the level of revenue achieved by particular slot lounges.

Contingent Rent

3. Lessees' Financial Statements

Example

- ABC Limited has signed a 5 years contract to lease a new office from 2007 to 2011 with a monthly rental payment of $20,000.
- ABC is granted with a rent-free period of 6 months in 2007.
- For the year end 31 December 2007, ABC paid rental of $120,000 and charged it to the income statement.
- Discuss.

3. Lessees' Financial Statements

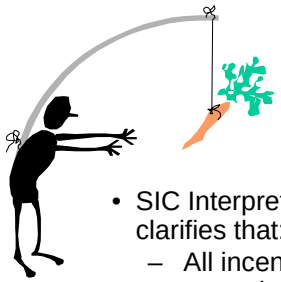
Answers

- IAS 17 requires that lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term.
- The payment made by ABC in 2007 only represents the cash flow ($120,000) and the lease expense for 2007 should be:

  $20,000 x (60 months – 6 months) ÷ 5 years = $216,000.
- In other words, a payable would be accounted for in the financial statements of 2007 as follows:

Dr.	Payable	120,000	
Cr.	Cash		120,000
	Being cash rental paid during 2007		
Dr.	Income statement	216,000	
Cr.	Payable		216,000
	Being the rental charges for 2007		

3. Lessees' Financial Statements



- SIC Interpretation 15 "*Operating Leases – Incentives*" also clarifies that:
  - All incentives for the agreement of a new or renewed operating lease shall be recognised as an integral part of the net consideration agreed for the use of the leased asset,
    - irrespective of the incentive's nature or form or the timing of payments ……
  - The lessee shall recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, on a straight-line basis
    - unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

3. Lessees' Financial Statements

Case

中國銀行(香港)
BANK OF CHINA (HONG KONG)

Accounting policy on operating lease (annual report 2005):

- Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor
  - are classified as operating leases.
- The total payments made under operating leases (net of any incentives received from the lessor) which include land use rights with payments that are separately identifiable at inception of the lease
  - are charged to the profit and loss account on a straight-line basis over the period of the lease.

3. Lessees' Financial Statements

Case

香港紅十字會
HONG KONG RED CROSS

Accounting policy on leased assets (annual report 2004):

- Leases where substantially all the risks and rewards of ownership of assets remain with the leasing company are accounted for as operating leases.
- Payments made under operating leases net of any incentives received from the leasing company are
  - charged to the income and expenditure account on a straight-line basis over the lease period.

3. Lessees' Financial Statements

Example

- Axe's financial year end is 31 December 2000. The company has also leased motor vehicles on 1 January 2000 for the first time.
- 50 vehicles were leased at an annual rental of $5,000 each, payable on 1 January in advance.
- In addition an extra $0.2 per kilometre is payable if the usage exceeds 50,000 kilometres over the three year rental period.
- The excess usage charge reflects fair compensation for the additional wear and tear of the vehicle.
- Axe returns the vehicle to the lessor at the end of the lease. The lessee maintains and insures the vehicles.
- Advise the financial director on the way in which the above transaction would be dealt with under current IASs.
  (A discount rate of 10% should be used for 3 years at 10% is $2.49.)

(Source from ACCA)

3. Lessees' Financial Statements

Answers

- Under existing accounting standards, the lease would be treated as an operating lease with any rental being charged to the income statement on a straight line basis over the lease term irrespective of the due dates of payment.
- Axe also has the right to purchase additional usage of the vehicles at $0.2 per kilometre.
- As this rate is fair compensation for additional wear and tear, the option has little value and would be ignored.
- Such rentals based on contingent usage would be recognised as incurred. (What is the implication of IAS 32?)

3. Lessees' Financial Statements

Example

- Inventure has paid an initial payment of $200,000 as a deposit under an operating lease.
- The payment
  - has been capitalised as a non-current tangible asset and
  - is to be amortised over the 5 year life of the operating lease.
- The initial payment
  - has substantially reduced the annual rental expense to $100,000 per annum.
- Discuss the nature and acceptability of the above accounting practice, advising the directors on the correct accounting treatment or actions that they should take.

(Source from ACCA)

3. Lessees' Financial Statements

Answers

- IAS 17 requires that operating lease rentals are charged to the income statement on a straight line basis over the lease term irrespective of when payments are due.
- A large up-front payment by the lessee should be allocated to the period over which the benefit is gained.
- The prepayment of the operating lease rental should be regarded as a prepaid lease payments and not as a non-current tangible asset.
- It should not be included in depreciation at a figure of $40,000 ($200,000 ÷ 5) but should be included in rental expense at this figure.
- Comparability will be affected if the classification of the premium results in high amortisation and low rental expense, especially if earnings before interest, tax, depreciation and amortisation is being used as a performance measure.

Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. Lessees' Financial Statements
4. **Lessors' Financial Statements**

Finance Lease

Operating Lease

After a proper classification is made from the lessor's view ……

4. Lessors' Financial Statements

Initial Recognition and Measurement

Lessors shall

a) recognise assets held under a finance lease in their balance sheets and

b) present them as a receivable at an amount equal to the net investment in the lease.

- Net investment in the lease is
  - the gross investment in the lease discounted at the interest rate implicit in the lease.
- Gross investment in the lease is the aggregate of:
  a) the minimum lease payments receivable by the lessor under a finance lease, and
  b) any unguaranteed residual value accruing to the lessor
- 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.

Finance Lease

4. Lessors' Financial Statements

Subsequent Measurement

- The recognition of finance income
  - shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease

Finance Lease

4. Lessors' Financial Statements

Leases for Manufacturer or Dealer Lessors

- Manufacturer or dealer lessors
  - shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.
- If artificially low rates of interest are quoted
  - selling profit shall be restricted to that which would apply if a market rate of interest were charged.

Finance Lease

- Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease
  - shall be recognised as an expense when the selling profit is recognised.

4. Lessors' Financial Statements

Example

- C&P Inc. was used to sell its self-manufactured motor car at $500,000 at cash price and the cost of the car was about $280,000.
- In order to boom its sale, C&P Inc. offers 2 plans of instalment sale to its customers:
  1. Customers can buy the car at $550,000 and repay the consideration in 12 equal instalment over a year at zero interest.
  2. Customers can buy the car at $500,000 and then arrange a 48-month instalment plan with the subsidiary of C&P Inc. and the interest rate is 10% per annum on the outstanding balance.
- Discuss the implication on the selling profit to C&P Inc.

- The outright profit on the sale is still $220,000 ($500,000 - $280,000).
- Even for plan 1, the selling profit should still be restricted to $220,000.
  - Since no interest (i.e. an artificially low rate of interest) is quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.
  - The excess of selling profit is an compensation on the loss of interest.

4. Lessors' Financial Statements

Disclosures

Lessors shall, in addition to meeting the requirements in IAS 32, disclose the following for finance leases:

a) a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
   i) not later than one year;
   ii) later than one year and not later than five years;
   iii) later than five years.

b) unearned finance income.

c) the unguaranteed residual values accruing to the benefit of the lessor.

d) the accumulated allowance for uncollectible minimum lease payments receivable.

e) contingent rents recognised as income in the period.

f) a general description of material leasing arrangements

Finance Lease

4. Lessors' Financial Statements

Recognition (Initial and Subsequent)

- Lessors shall present assets subject to operating leases in their balance sheets according to the nature of the asset.
- Lease income from operating leases
  - shall be recognised in income on a straight-line basis over the lease term
  - unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished

Operating Lease

4. Lessors' Financial Statements

Recognition (Initial and Subsequent)

- Initial direct costs incurred by lessors
  - shall be added to the carrying amount of the leased asset and
  - recognised as an expense over the lease term on the same basis as the lease income
- Depreciation policy for depreciable leased assets
  - shall be consistent with the lessor's normal depreciation policy
  - depreciation shall be calculated in accordance with IAS 16 and 38

Operating Lease

4. Lessors' Financial Statements

Disclosures

- Lessors shall, in addition to meeting the requirements of IAS 32, disclose the following for operating leases:
  a) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
     i) not later than one year;
     ii) later than one year and not later than five years;
     iii) later than five years.
  b) total contingent rents recognised as income in the period.
  c) a general description of the lessor's leasing arrangements.

Operating Lease

4. Lessors' Financial Statements

Example

- Very Wealthy acquired a shopping mall on 1 April 2005 at HK$450 million and partly financed by the HK$400 million loan.
- The shopping mall is now 80% occupied and all the leases started on 1 April 2004 and the tenancy agreements are summarised below:

Nature of tenants	Rental arrangements	Rental for the year ended 31 March 2005
A supermarket by a large private enterprise	Under a 30-year lease with fixed monthly rental plus a percentage of the tenant's annual turnover. A rent-free period for the first 5 years was granted.	N/A [Annual fixed rental of HK$15 million payable from 1/4/2009 to 1/4/2033. Based on 2005 figures, the share of the turnover of the supermarket should have been HK$3 million.]

- For Very Wealthy's consolidated financial statements for the year ended 31 March 2006, determine how the lease payments should be recognised, measured and disclosed. *(Source from HKICPA)*

4. Lessors' Financial Statements

Answers

- The agreement with the supermarket is likely to be <u>an operating lease</u>.
- Even though the lease term accounts for two-third of the shopping mall's land use right/useful life (or the shopping mall's estimated useful life), it is <u>not likely that substantially all the risks and rewards incident to the ownership have been transferred</u> to the tenant.
- In accordance with IAS 17, the lease income from these operating leases <u>shall be recognised in income on a straight-line basis over the lease term</u>
  - unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.
- <u>All incentives</u> for the operating leases shall be recognised as an integral part of the net consideration agreed for the use of the leased units, and <u>should be recognised as a reduction of rental income over the lease term, on a straight-line basis</u>
  - unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished.

4. Lessors' Financial Statements

Answers

- In accordance with IAS 17, the company should disclose a general description of the leasing arrangements, and an analysis of future minimum lease payments under noncancellable leases, with the amount receivable analysed into (1) not later than one year; (2) later than one year and not later than five years; and (3) later than five years.
- The annual fixed rental income from the supermarket recognised in the profit or loss for the year ended 31 March 2006 should be $12,931,035 per annum [($15 million x 25 years) ÷ 29 years].
- The amount of future minimum lease payments receivable from the lease of the supermarket to be included in the analysis at 31 March 2006 would be:

1) not later than one year :	$ 0
2) later than one year and not later than five years (01/04/2009 and 01/04/2010)	$30 million
3) later than 5 years (01/04/2011 and onwards)	$345 million

Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. Lessees' Financial Statements
4. Lessors' Financial Statements
5. **Sale and Leaseback Transactions**

5. Sale and Leaseback Transactions

If a sale and leaseback transaction results in → Finance Lease

- Any excess of sales proceeds over the carrying amount
  - shall not be immediately recognised as income by a seller-lessee
- Instead, it shall be deferred and amortised over the lease term

5. Sale and Leaseback Transactions

Example

- Axe's financial year end is 31 Dec. 2000.
- On 1 Jan. 2000, Axe sold plant with a carrying value of $200 million.
- The fair value and selling price of the plant was $330 million.
- The plant was immediately leased back over 4 years which is the remaining useful life of the asset.
- Axe has guaranteed a residual value of $30 million and the plant is to be sold for scrap at the end of the lease. Axe will be liable for any shortfall in the residual value.
- The lease cannot be cancelled and requires equal rental payments of $87 million at the commencement of each financial year.
- The "normal" cost of such a lease without the residual value guarantee would have been $95 million per annum.
- Axe pays the costs of all maintenance and insurance of the plant.
- Advise the financial director on the way in which the above transaction would be dealt with under current IAS.
- A discount rate of 10% should be used for 3 years at 10% is $2.49.

(Source from ACCA)

5. Sale and Leaseback Transactions

Answers

- The sale and leaseback of the plant appears to create a finance lease as the present value of the minimum lease payments is substantially all (98%) of the fair value of the plant and Axe pays all the costs of maintenance and insurance of the plant.
- The lease runs for the useful life of the plant and Axe has guaranteed a residual amount of $30 million. Thus the minimum lease payments are:

	$ million
$87 million + $87 million x 2.49	303.6
$30 million residual value discounted at 10%	20.5
	324.1

- IAS 17 states that if a sale and leaseback transaction results in a finance lease, any excess of sale proceeds over the carrying amount should not immediately be recognised as income.
- Instead it should be deferred and amortised over the lease term.The earnings process is not complete and a sale has not occurred.
- The rental payments have been reduced because the company has been prepared to guarantee a residual value of $30 million which is probably in excess of its scrap value which will potentially be low.

5. Sale and Leaseback Transactions

If a sale and leaseback transaction results in → **Operating Lease**

- The asset's Sales Price is compared with its Fair Value

Sales Price = Fair Value
- Profit / loss shall be *recognised immediately*

Sales Price < Fair Value
- Profit / loss shall be *recognised immediately* except that:

  If the loss is compensated by future lease payments at below market price

  ⇒ The loss shall be *deferred and amortised* in proportion to the lease payments over the period for which the asset is expected to be used.

Sales Price > Fair Value
- The excess over fair value shall be *deferred and amortised* over the period for which the asset is expected to be used

5. Sale and Leaseback Transactions

If a sale and leaseback transaction results in → **Operating Lease**

- The asset's Sales Price is compared with its Fair Value
- If the Fair Value at the time of a sale and leaseback transaction is less than the Carrying Amount of the asset

Fair Value < Carrying Amount

  - a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately

5. Sale and Leaseback Transactions

Disclosure in respect of sale and leaseback transactions

- Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions.
- The required description of material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.
- Sale and leaseback transactions may trigger the separate disclosure criteria in IAS 1 *Presentation of Financial Statements*.

5. Sale and Leaseback Transactions

Example

- Axe's financial year end is 31 Dec. 2000.
- On 1 Jan. 2000, Axe sold its computer software and hardware to Lake, a public limited company, for $310 million.
- The assets were leased back for 4 years under an operating lease whereby Lake agreed to maintain and upgrade the computer facilities.
- The fair value of the assets sold was $190 million.
- The carrying value based on depreciated historical cost was $90 million.
- The lease rental payments were $45 million per annum, payable on 1 Jan. in advance, which represented a premium of 50% of the normal cost of such a lease.
- Advise the financial director on the way in which the above transaction would be dealt with under current IAS.
- A discount rate of 10% should be used for 3 years at 10% is $2.49.

(Source from ACCA)

5. Sale and Leaseback Transactions

If a sale and leaseback transaction results in → **Operating Lease**

- The asset's Sales Price is compared with its Fair Value

Sales Price > Fair Value

- The excess over fair value shall be *deferred and amortised* over the period for which the asset is expected to be used

5. Sale and Leaseback Transactions

Answers

- The assets which have been sold and leased back (the computer software and hardware) should be treated as a sale and the operating lease treated under IAS 17 which would keep the lease off the balance sheet and only charge the rentals against profit.
- If the transaction is at fair value then immediate recognition of the profit or loss on the sale of the asset should occur.
- However, where the transaction is above fair value, the profit based on fair value should be recognised immediately ($190 million - $90 million, i.e. $100 million).
- The balance of the sales value over the fair value should be deferred and amortised over period for which the asset is expected to be used (($310 million - $190 million) / 4 years, i.e. $30 million per annum).
- However, as the sales value is not the fair value, it is evident that the rental payments have been adjusted for the excess price paid for the assets and it appears that the substance of the transaction is the sale of an asset and a loan which equates to the deferred income element.
- Thus the premium of $15 million may be more a financing cost with the excess over the fair value being shown as a loan ($120 million) with part of the costs of the operating lease being treated as repayment of capital and interest.

Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. Lessees' Financial Statements
4. Lessors' Financial Statements
5. Sale and Leaseback Transactions
6. **Transitional Provisions**

6. Transitional Arrangements

- Subject to IAS 17.68 (as set out in next slide),
  - retrospective application of IAS 17 is encouraged but not required.
- If IAS 17 is not applied retrospectively,
  - the balance of any pre-existing finance lease
    - is deemed to have been properly determined by the lessor and
    - shall be accounted for thereafter in accordance with the provisions of IAS 17.

6. Transitional Arrangements

- An entity that has previously applied IAS 17 (revised 1997) shall apply the amendments made by IAS 17 *retrospectively*
  - for all leases or,
  - if IAS 17 (revised 1997) was not applied retrospectively, for all leases entered into since it first applied IAS 17.

Retrospective Application

⇒ as if that policy had always been applied
⇒ restate opening balance of retained earnings
⇒ restate comparative figures

6. Transitional Arrangements

Case

中国联通 CHINA UNICOM

(announcement on 28.04.2005)

- Under HKAS 17 *Leases*, land use right in the PRC
  - is no longer accounted for as PPE
  - instead, it is
    - reclassified as other assets – long-term prepayment of lease
    - which is stated at cost and
    - recognised as an expense on a straight-line basis over the lease term
- This policy was adopted by the Group from 1 Jan. 2005 and applied retrospectively.

Retrospective Application

6. Transitional Arrangements

Case

Annual report 2005:

- In the current year, the Group has applied HKAS 17 "Leases" …… the leasehold interests in land
  - are reclassified to prepaid lease payments under operating leases ……
  - which are carried at cost and amortised over the lease term on a straight-line basis.
- The surplus on revaluation in respect of the land interests accounted for as property, plant and equipment previously recognised in the asset revaluation reserve was adjusted retrospectively.
- Comparative figures for 2004 have been restated.

Retrospective Application

Hysan 希慎

Today's Agenda

1. Objective and Scope
2. Classification of Leases
   - Classification of Land and Buildings
3. Lessees' Financial Statements
4. Lessors' Financial Statements
5. Sale and Leaseback Transactions
6. Transitional Provisions
7. **Implementation Issues**

7. Leases – Implementation Issues

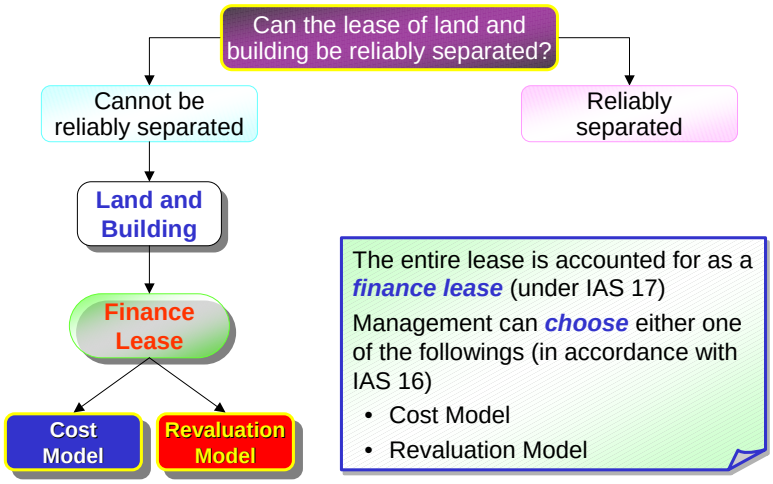
Can the lease of land and building be reliably separated?

- Cannot be reliably separated
  - **say, "buy" a flat on 2nd hand market**
- Reliably separated
  - **e.g. lease a land and then construct a building there**

香港交易所 HKEx

HKEx has reliably allocated the lease payments between land and building!
Can all companies do that on all leases?

7. Leases – Implementation Issues

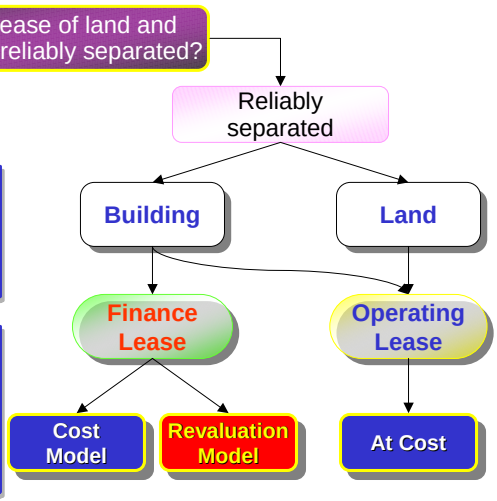


The entire lease is accounted for as a ***finance lease*** (under IAS 17)

Management can ***choose*** either one of the followings (in accordance with IAS 16)

- Cost Model
- Revaluation Model

7. Leases – Implementation Issues



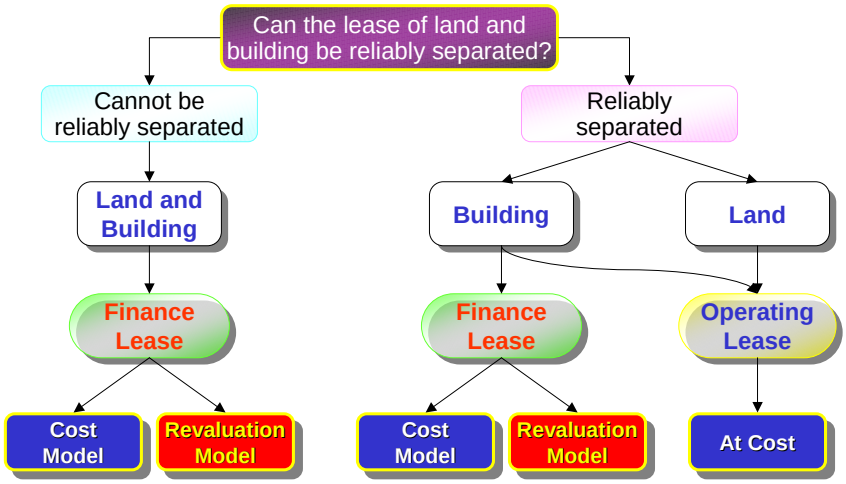
Land (no choice as under an operating lease)

- Prepaid lease payments (i.e. cost) amortised over lease term

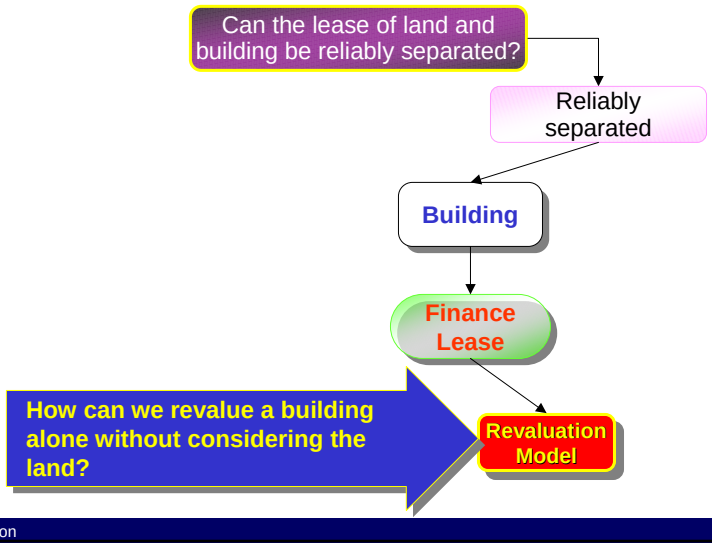
Building: management can choose between (in accordance with IAS 16)

- Cost Model or
- Revaluation Model

7. Leases – Implementation Issues



7. Leases – Implementation Issues



7. Leases – Implementation Issues

Case

As stated previously:

"The *lease premium for land* is stated *at cost* and *amortised* over the period of the lease whereas the *leasehold building* is stated at *valuation* less accumulated depreciation." *2004 Annual Report, HKEX (28 Feb. 2005)*

Finance Lease → **Revaluation Model**

香港交易所 HKEx

7. Leases – Implementation Issues

Case

"The building component of owner-occupied leasehold properties are stated at valuation less accumulated depreciation. Fair value is determined by the Directors based on independent valuations which are performed periodically."

"The valuations are on the basis of depreciated replacement cost."

"Depreciated replacement cost is used as open market value cannot be reliably allocated to the building component." *2004 Annual Report, HKEX*

IAS 16 (para. 33) states:

If there is no market-based evidence of fair value because of

- the specialised nature of the item of PPE and
- the item is rarely sold, except as part of a continuing business,

an entity may need to estimate fair value using

- an income or
- a depreciated replacement cost approach.

7. Leases – Implementation Issues

Case

- Freehold land and buildings, and the building component of owner-occupied leasehold properties are stated at valuation.
- Independent valuations are performed every three years on an open market basis and, in the case of the building component of leasehold properties, on the basis of depreciated replacement cost.
  - Depreciated replacement cost is used as the most reliable basis of allocating open market value to the building component.

2005 Annual Report, Jardines Group

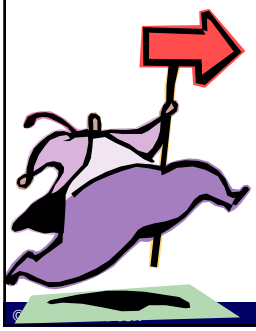
Finance Lease → **Revaluation Model**

What is depreciated replacement cost?

7. Leases – Implementation Issues

Replacement Cost

Less: Depreciation



International Valuation Guidance Note No. 8 defines

Depreciated replacement cost

- The current cost of reproduction or replacement of an asset

  Less: deductions for physical deterioration and all relevant forms of obsolescence and optimisation.
- It is an application of the cost approach used in assessing the value of specialised assets for financial reporting purposes, where direct market evidence is limited.
- As an application of the cost approach, it is based on the principle of substitution.

What is depreciated replacement cost?

Leases (IAS 17)

March 2007

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Leases (IAS 17)

March 2007

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