LOYSON consulting
Accounting and Tax Specialists

LEASING AN ASSET

Part 1 – accounting considerations

The decision to purchase an asset as opposed to leasing an asset is extremely important. In our series of newsletters we will address the following issues:

- Leasing from an Accounting perspective (Part 1)
- Leasing from an Income Tax and Value-Added-Tax perspective (Part 2)
- Accounting and Taxation considerations on the termination of a lease (Part 3)
- Integrated reporting including sale and leaseback of assets (Part 4)

The accounting requirements for leasing an asset whether we are looking at it from the lessor or the lessees' perspective is controlled within IAS17. IAS17 distinguishes between two types of leases:

- Finance lease
- Operating lease

A finance lease is defined in IAS17. If the lease does not meet the definition of a finance lease then the lease is an operating lease.

The definition of a finance lease in IAS17 is based on the principle of substance over form. [In other words, a contract to lease an asset may result in the lease being classified as a finance lease based on the substance of the transaction rather than the legal form.] IAS17 para 10 illustrates the following examples which would normally lead a lease to be classified as a finance lease:

a) Transfer of ownership at the end of the lease term;
b) Bargain purchase option;
c) Lease is for the major economic life of the asset;
d) At 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 asset is a specialized asset that only the lessee can use

Once the lease is classified as a finance lease what is the effect of this classification?

From the lessee's perspective, the leased asset will be capitalized into the accounting records together with the finance liability at the lower of the present value of the minimum lease payments or fair value. 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 rate cannot be determined it will be the lessee's incremental borrowing rate. Two important definitions we need to understand are:

- Minimum lease payments
- Interest rate implicit in the lease

Minimum lease payments are the payments over the lease term, excluding contingent payments, including any guaranteed future payments. Should there be a bargain purchase and there is reasonable certainty that the option will be exercised the minimum lease payments includes the option price.

Interest rate implicit in the lease is the discount rate that, at the aggregate present

value of the minimum lease payments and the unguaranteed residual to be equal to the sum of the fair value of the asset and any initial direct costs of the lessor.

The unguaranteed residual is that portion of the residual value of the leased asset that is not assured or guaranteed.

Example 1

A Ltd leases an item of machinery which had a fair value of R 100 000. Initial legal costs of R 1 000 were incurred by the lessor. A Ltd pays two annual payment of R 55 000 in arrears together with a guaranteed future value of R 6 000. The unguaranteed residual is R 4 000.

The interest rate implicit in the lease is calculated as follows
PMT = 55 000
Nper=2
FV = (6 000 + 4 000)
PV = 100 000 + 1 000
Comp I = 11.945%

Once the interest rate implicit in the lease has been determined then we can apply this rate to the lessee to determine the present value of the minimum lease payments as follows:

Pmt = 55 000
FV = 6 000
I = 11.945
N = 2
Comp pv = R 97 808

The present value for the lessee was calculated based on the minimum lease payments which exclude the unguaranteed residual value.

The entry to be passed in the accounts would be to debit the leased asset and credit the finance lease obligation with R 97 808.

The leased asset will then be depreciated in terms of IAS16 over the term of the lease. Where the ownership of the asset transfers at the end of the lease, the depreciation period should be the useful life of the asset and not the lease term. The entry in the books will be debit depreciation (R 48 904) and credit leased asset.

The finance lease obligation will decrease over the term of the lease to zero. The minimum lease payments must be apportioned between interest, capital and VAT. The VAT component will be addressed in Part 2. The allocation of the minimum lease payments is best calculated using an amortisation table. The entry for the current year would be debit finance lease obligation (R 43 416 – capital portion) debit interest (R 11 683) and credit bank with R 55 000.

To summarise the financial impact at the end of year 1:
<u>Statement of Financial Position</u>
Leased asset: R 48 904
Lease liability: R 54 491
<u>Statement of Comprehensive Income</u>
Finance charges: R11 683
Depreciation: R 48 904
<u>Statement of Cash Flows</u>
Lease payment: R 55 000

Additional commentary for the lessee on example 1:

- It is unlikely that a lease will have a guaranteed residual value and an unguaranteed residual.
- It is also unlikely that in determining the interest rate implicit in the lease the lessee will be privy to the lessor initial direct costs. In this event, the standard allows the lessee to use the lessee's incremental borrowing rate of interest which is the rate of interest the lessee will pay on similar leases and if this is not determinable, 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 the asset is financed through a financial institution, there will be no unguaranteed residual as the asset will not be given back to the bank on conclusion of the lease.
- Unguaranteed residuals are common in scenarios where the assets useful life is 5 years and the lease is

for 4 years after which the asset will be returned to the lessor.

The income tax and VAT treatment will be dealt with in Part 2.

From the lessor perspective, the treatment is fairly similar. Paragraph 36 of IAS 17 requires lessors to recognize as a receivable an amount equal to the net investment in the lease. The term net investment in the lease is defined as the gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is defined as the minimum lease payments receivable under the lease (see above) and the unguaranteed residual. Using example 1 and assuming the lessor is a finance house type lessor as opposed to a manufacturer/dealer, the following are the accounting entries that needs to be passed:

The bank would have debited the asset in terms of the lease agreement and paid the supplier. Then the bank would debit the lease receivable and credit the asset with R 101 000 (see below the composition of this amount).

The gross investment in the lease is R 120 000 and is calculated as follows: the minimum lease payments of R 110 000 (R 55 000 x 2) + R 6 000 PLUS the unguaranteed residual of R 4 000. The net investment in the lease is the present value of the gross investment using the interest rate implicit in the lease.

PMT = 55 000
Nper=2
FV = (6 000 + 4 000)
I = 11.945%
Comp PV = 101 000

Therefore, the lessor would debit the lease receivable account with R 120 000 (gross investment in the lease) and credit unearned finance income with R 19 000 and credit the asset and legal costs with R 100 000 and R 1 000 respectively.

As with the lessee, the payment of R 55 000 that is paid to the lease at the end of year 1 will be allocated between three components:

a) Interest
b) VAT
c) Capital

To summarise the financial impact at the end of year 1:

Statement of Financial Position
Leased receivable: R 58 064
Statement of Comprehensive Income
Finance income: R12 064
Statement of Cash Flows
Lease receipt: R 55 000

For year 2, similar treatment however there is one further entry that needs to be passed to take into account the unguaranteed residual. After allocating the minimum lease payments we are left with a lease receivable of R 4 000. This represents the unguaranteed residual. As the asset is returned to the lessor, the entry that needs to be passed is to debit the owned asset and credit the lease receivable with R 4 000.

In example 1 above, we have assumed that the lessor is a financial institution (i.e. there will be three parties to the contract: lessee, lessor and the supplier). The business objectives of a financial institution is to finance transactions/entities and thereby earn interest on their investments. Their business objective is not to make a profit from the purchase and subsequent disposal in terms of a finance lease. The standard recognizes that certain entities manufacture the products and lease the products directly to the lessee's (manufacture /dealer lessors). Manufactures or dealers will often manipulate interest rates as a marketing tactic to secure the contract. Deals such as: the purchase of an asset during a specific month and pay interest at 0%

(from a management perspective clearly the selling price has been inflated to offer the financing arrangement at an interest of 0%). The charging of interest at 0% does not represent economic reality and the standard in para 42 has addressed this issue. It states that where artificially low interest rates are charged, the selling profit must be restricted to an amount calculated based on a market rate of interest.

One of the disadvantages of inflating the selling price is that VAT will be calculated on the stated selling price in terms of the lease contract. This will be addressed in Part 2.

Example 2

A motor dealer acquired a vehicle from the manufacturer at a cost of R 100 000. On the same date it enters into a finance lease with a customer. The selling price was set at R 250 000 in terms of the lease agreement. 0% interest will be charged resulting in four equal payments of R 62 500 payable annually in arrears. A commercial interest rate for transaction of this type is 15%.

The entries that need to be passed are as follows:

On acquiring the asset, debit inventory and credit bank/supplier with R 100 000. The asset has been "disposed" and the asset will be de-recognized as follow: debit the cost of sales account and credit inventory with R 100 000.

The gross investment in the lease will be the future payments of R 250 000 (R 62 500 x 4). The net investment in the lease is calculated as follows:

PMT = 62 500
Nper=4
FV = 0
I = 15%
Comp PV = 178 436

The following entry will be debit the gross investment in the lease account with R 250 000 and credit unearned finance income with R 71 564 and credit revenue with R 178 436.

Subsequently the lease payment will be split into the three components (interest/capital/VAT) based on the preparation of an amortization table. At the end of year 1, bank will be debited with the lease receipt of R 62 500 and finance income will be credited with R 26 765 and the balance of R 35 734 credited to the finance lease receivable account.

To summarise the financial impact at the end of year 1:

<u>Statement of Financial Position</u>
Leased receivable: R 142 701
<u>Statement of Comprehensive Income</u>
Finance income: R26 765
Gross profit: R78 436
<u>Statement of Cash Flows</u>
Lease receipt: R 62 500

In part 2, we will address the impact of deferred tax and VAT with respect to leases.