



## Article topic: Financial Reporting

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# Accounting for Leases and Hire Purchase Contracts

In this article Steve Collings take a look at the accounting treatment for leases and Hire Purchase contracts from the perspective of both the lessee and the lessor.

Accounting for leases and hire purchase contracts are dealt with in the provisions in SSAP 21 '*Accounting for Leases and Hire Purchase Contracts*' and IAS 17 '*Leases*'. In some instances some lease transactions can form part of a complex arrangement or which contain options, provisions and guarantees which could well fall within the scope of FRS 5 '*Reporting the Substance of Transactions*'. It should be noted at this point that where such a lease falls under the scope of SSAP 21 and FRS 5, the standard containing the more specific provision will apply.

### **Operating and Finance Leases**

An operating lease is a lease that is not a finance lease. Payments under an operating lease are taken to the profit and loss account (statement of comprehensive income) on a straight-line basis over the lease term unless another systematic basis is more appropriate.

SSAP 21 at paragraph 17 defines a finance lease as '*...a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee*'. SSAP 21 also defines an operating lease as simply '*...a lease other than a finance lease*'.

Whether or not a lease passes substantially all the risks and rewards of ownership will usually be clear in the lease terms. IAS 17 stipulates guidance when substantially all the risks and rewards of ownership are passed to the lessee:

- The lease transfers ownership to the lessee at the end of the lease term.
- The lease contains a bargain purchase option at the end of the lease term.
- The lease term is for the major part of the asset's useful economic life.
- The present value, at the inception of the lease, of the minimum lease payments is at least equal to substantially all of the fair value of the leased asset, net of grants and tax creditors to the lessor at that time (title may or may not eventually pass to the lessee).
- The leased assets are of such a specialised nature that only the lessee can use them without modifications being made.

IAS 17 goes on to offer a further three indicators which may suggest that a lease might be properly considered as a finance lease:

- If the lessee can cancel the lease, the lessor's associated costs with the cancellation are to be borne by the lessee.
- Gains or losses arising from the fluctuation of fair value of the residual amount will accrue to the lessee.
- The lessee has the ability to continue the lease for a supplemental term at a rent that is substantially lower than market rent (a 'peppercorn' rent).

SSAP 21, on the other hand, sets a simple test to determine whether a lease is a finance lease:

*'It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset'* SSAP 21 paragraph 15.

In contrast to SSAP 21 90% 'yardstick' approach, IAS 17 refers to '*...at least equal to substantially all of the fair value of the leased asset...*'

### Minimum Lease Payments

The minimum lease payments in the lease can be calculated once the lease term has been established and they should then be discounted to present day values. Minimum lease payments are the minimum payments that the lessee is committed to be made during the term of the lease. SSAP 21 at paragraph 20 defines the composition of the minimum lease payments as:

- Any initial payment the lessee makes.
- The minimum rentals over the lease term (excluding charges in respect of services, such as maintenance and Value Added Tax).
- Any amounts guaranteed by the lessee, or by a third party related to him, to the lessor in respect of the realisation of the asset at the end of the lease term.

The problem with this benchmark test in SSAP 21 is that it does not establish exactly where the risks and rewards lie. It is important therefore that the contractual terms of the lease are carefully scrutinised in order to ensure correct classification as either a finance or operating lease.

### Interest Rate Implicit in the Lease

The interest rate implicit in the lease is the discount rate that, when applied at the start of the lease to the amounts that the lessor expects to receive produces a present value which is equivalent to the fair value of the leased asset. SSAP 21 at paragraph 24 states the amounts that the lessor expects to receive in the lease are:

- The lessee's minimum lease payments.
- Any further amounts guaranteed by third parties in respect of the asset's residual value.
- The asset(s) expected residual value at the end of the lease, which is not guaranteed by the lessee or any other party.
- Less any amounts for which the lessor will be accountable to the lessee.

### Land and Buildings

Leases of land and buildings are still governed by the principles in SSAP 21 and IAS 17. Again, it is important that the terms of the lease are carefully scrutinised in order that correct classification is made. In the United Kingdom most land and buildings leases are for periods of 20 to 30 years and these are generally considered 'short' leases and are more likely to be operating leases rather than finance leases. However, just because a lease may be a 'short' lease does not necessarily preclude the lease from being a finance lease. Some leases may contain clauses and be structured in such a way that their legal form might be a 'short' lease, but the lease could have the characteristics of being a finance lease. The concept of 'substance over form' is particularly relevant in these circumstances.

In contrast to 'short' leases, 'long' leases (such as those for 99 years and over) are likely to be finance leases and may involve a large lease premium being paid with annual ground rent payments. In these circumstances, the lease premium is capitalised and depreciated over the term of the lease.

### Lease Incentives

It is not uncommon for landlords to offer incentives for lessee's to sign operating leases such as rent-free or rent-reduced periods. A Task Force Abstract (UITF 28) was issued in February 2001 which clarifies the requirements of SSAP 21.

Paragraph 8 of UITF states:

*'In accordance with the accruals concept, any incentive should be allocated to match the effect of the increased rentals payable in later periods, so that the financial statements reflect the true effective rental for the premises, irrespective of the particular cash flow arrangements agreed between the parties. The accounting treatment should be similar, however the arrangement is structured.'*

## **Accounting by Lessee – Operating Lease**

Payments in respect of operating leases are charged to the profit and loss account (statement of comprehensive income) on a straight-line basis over the lease term unless another systematic basis is more appropriate.

## **Accounting by Lessee – Finance Lease**

A finance lease is recorded in the lessee's balance sheet (statement of financial position) as a fixed (non-current) asset together with a corresponding creditor to as an obligation to pay future rentals. The amount recorded in the balance sheet (statement of financial position) should be the present value of the minimum lease payments which are arrived at by discounting them at the interest rate implicit in the lease.

Assets under finance leases are depreciated over the shorter of the lease term and its useful economic life. Assets held under hire purchase contracts which have the characteristics of finance leases should be depreciated over the asset's useful life.

## **Accounting by Lessor – Operating Lease**

The lessor should record a fixed (non-current) asset and depreciate that asset over its useful economic life. Lessors should also recognise rental income from the operating lease (excluding service charges such as insurance and maintenance) on a straight-line basis over the period of the lease, regardless of when payments are received. This is to ensure the 'accruals' concept is adhered to. However, where another systematic and rational basis gives a more representative time pattern in which the lessor receives the benefit from the leased asset then the straight-line basis of rental income recognition over the period of the lease need not apply.

## **Accounting by Lessor – Finance Lease**

The amount due from the lessee under a finance lease should be recorded as a debtor. At the start of a finance lease, the lessor's net investment in the leased asset is its cost. Over the lease term, lease rentals should be apportioned between a reduction in the net investment in the lease and gross earnings.

Under the provisions of SSAP 21, the total gross earnings under a finance lease should be allocated to each accounting period in such a way that it produces a constant rate of return on each period's net cash investment. This method is used because it properly matches the gross earnings with the interest costs of funding the net cash investment in the lease. However, SSAP 21 does permit alternative methods of allocate gross earnings if an alternative method produces a better systematic basis.

## **Conclusion**

Before accounting standards were introduced for leasing arrangements, it was not uncommon for entities to manipulate the financial statements in respect of leases by ignoring the concept of 'substance over form' and therefore understating liabilities because entities were concluding that because they were not the legal owner of the assets, then neither the asset subject to the lease was

recognised in the balance sheet (statement of financial position) and neither was the associated liability.

In many cases it is somewhat clear whether a lease is a finance or operating lease, but in certain situations it may not be necessarily clear and it is therefore vital that the contractual terms of the lease are scrutinised carefully to ensure the correct accounting treatment.

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