Chapter 6 HKAS 17 Leases – Answers

**Answer 1**

The contracted lease term is only for half of the useful life of the machine and there is no strong likelihood that the company will exercise the option in four years’ time, because the option is priced at fair value, not a discount. Thus the risks and rewards of ownership have not passed to the lessee and these lease should be treated as an operating lease.

**Answer 2**

Allocate finance charge on an actuarial basis.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 |
| Year | Capital sum at start of period | Lease payment | Sub-total | Finance charge at 15.15% pa | Capital at year end |
|  | $ | $ | $ | $ | $ |
| 2015 | 20,000 | 5,200 | 14,800 | 2,242 | 17,042 |
| 2016 | 17,042 | 5,200 | 11,842 | 1,794 | 13,636 |
| 2017 | 13,636 | 5,200 | 8,436 | 1,278 | 9,714 |
| 2018 | 9,714 | 5,200 | 4,514 | 686 | 5,200 |
| 2019 | 5,200 | 5,200 | - | - | - |

**Non-current liability at 31 December 2015**

|  |  |
| --- | --- |
| Amounts due under finance lease (17,042 – 5,200) | $11,842 |

In this situation the lease payments are in advance. So the next payment is due in 1 day and the year end current liability includes the current year’s finance charge (which has accrued but not been paid). To calculate the non-current liability, the full amount of the next payment is deducted from the year end capital balance.

**Answer 3**

**(a)**

The annual rental charge will be $880,000. Boro will pay $8,800,000 over the ten years of the lease. (There is one rent-free year and Boro receives $200,000 towards its relocation costs.)

**(b)**

At the end of Year 1 there will be an accrual of $1,080,000 in the statement of financial position. This is because Boro will have charged $880,000, but paid nothing and received $200,000 of incentives. The chart below shows how the accrual gets used up over the life of the lease.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **A** | **B** | **A – B** |  |  |
| Year | Cash payment | Charge | Difference | Cumulative difference |  |
|  | $000 | $000 | $000 | $000 |  |
| 1 | (200) | 880 | – 1,080 | – 1,080 | Accrual |
| 2 | 1,000 | 880 | +120 | – 960 |  |
| 3 | 1,000 | 880 | +120 | – 840 |  |
| 4 | 1,000 | 880 | +120 | – 720 |  |
| 5 | 1,000 | 880 | +120 | – 600 |  |
| 6 | 1,000 | 880 | +120 | – 480 |  |
| 7 | 1,000 | 880 | +120 | – 360 |  |
| 8 | 1,000 | 880 | +120 | – 240 |  |
| 9 | 1,000 | 880 | +120 | – 120 |  |
| 10 | 1,000 | 880 | +120 | Nil |  |
|  | 8,800 | 8,800 |  |  |  |
|  | Cash flow statement | Income statement |  | Statement of financial position |  |

**(c)**

Extracts from the notes to the balance sheet at the end of Year 1 Boro is committed to making the following minimum lease payments under non-cancellable operating lease agreements:

|  |  |
| --- | --- |
|  | $ |
| Within one year | 1,000,000 |
| Between two to five years | 4,000,000 |
| After five years | 4,000,000 |
|  | 9,000,000 |

**Answer 4**

**(a)**

The annual rental income will be $85,000. The total cash income over the seven years of the lease is $595,000. This is claimed on a straight-line basis.

**(b)**

Extracts from the income statement and statement of financial position for 2012 and 2013.

|  |  |  |
| --- | --- | --- |
|  | 2012 | 2013 |
| Income statement | $ | $ |
| Operating income: Rentals receivable | 85,000 | 85,000 |
| Operating expenses: Depreciation | (35,200) | (35,200) |
|  | 49,800 | 49,800 |
|  |  |  |
| Statement of financial position |  |  |
| **Non-current assets** |  |  |
| Equipment held for use in operating leases |  |  |
| Cost | 880,000 | 880,000 |
| Accumulated Depreciation | (35,200) | (70,400) |
| Carrying value | 844,800 | 809,600 |
|  |  |  |
| **Non-current liabilities** |  |  |
| Deferred income | 75,000 | 75,000 |
|  |  |  |
| **Current liabilities** |  |  |
| Deferred income | 15,000 | 15,000 |

Working for deferred income

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **A** | **B** | **A – B** |  |
| Year | Cash received | Income claimed | Difference | Cumulative difference |
|  | $ | $ | $ | $ |
| 2015 | 175,000 | 85,000 | 90,000 | 90,000 |
| 2016 | 70,000 | 85,000 | (15,000) | 75,000 |

**(c)**

Oroc has the following minimum non-cancellable lease payments receivable at the statement of financial position date:

|  |  |  |
| --- | --- | --- |
|  | 2015 | 2016 |
|  | $ | $ |
| Within one year | 70,000 | 70,000 |
| Between two to five years | 280,000 | 280,000 |
| After five years | 70,000 | 0 |
|  | 420,000 | 350,000 |

**Answer 5**

Under HKAS17, ‘Leases’, **operating lease payments** should be **recognised as an expense in the income statement over the lease term on a straight line basis**, **unless another systematic basis is more representative** of the time pattern of the user’s benefit.

The **provisions of the lease have changed significantly** and would **need to be reassessed**.

The **lease term is now** for the **major part of the economic life** of the assets, **and** at the inception of the lease, the **present value of the minimum lease payments is substantially all of the fair value of the leased asset**. (Fair value $35 million, NPV of lease payments $34·1 million) **Even** if **title is not transferred** at the end of the lease the **lease can still be a finance lease**.

Any **change in the estimate of the length of life** of a lease **would not change its classification** **but** where the **provisions of the lease have changed**, **re-assessment of its classification takes place**. Thus it would appear that the **lease is now a finance lease**, and it would be **shown in the statement of financial position at the present value of the lease payments as this is lower than the fair value**.

This change in classification will **not affect ROCE** as it will **increase non-current assets by $34·1 million and liabilities by the same amount**.

**Answer 6**

**(a)**

On sale of the building, Holcombe will recognise the following in the financial statements to 30 April 2010:

|  |  |  |
| --- | --- | --- |
|  | Dr. ($m) | Cr. ($m) |
| Cash | 150 |  |
| Office building |  | 120 |
| Deferred income |  | 30 |
| (Recognition of gain on the sale of the building) |  |  |
|  |  |  |
| Deferred income (SOFP) | 6 |  |
| Deferred income (I/S) |  | 6 |
| (Release of the gain on sale of the building ($30m/5 years) | |  |
|  |  |  |
| Operating lease asset ($16m × 3.993) | 63.89 |  |
| Obligation to pay rentals |  | 63.89 |
| (Recognition of the leaseback at net present value of lease payments using 8% discount rate) | | |

In the first year of the leaseback, Holcombe will recognize the following:

|  |  |  |
| --- | --- | --- |
|  | Dr. ($m) | Cr. ($m) |
| Lease obligation – rentals | 16 |  |
| Cash |  | 16 |
| (Recognition of payment of rentals) |  |  |
|  |  |  |
| Interest expense | 5.11 |  |
| Lease obligation |  | 5.11 |
| (Recognition of interest expense ($63.89m × 8%)) |  |  |
|  |  |  |
| Depreciation expense | 12.78 |  |
| Right-of-use asset |  | 12.78 |

Recognition of depreciation of operating lease asset over five years ($63·89m/5 years). The statement of financial position will show a carrying value of $51·11m being cost of $63·89m less depreciation of $12·78m.

**(b)**

Inflation adjustments should be recognised in the period in which they are incurred as they are effectively **contingent rent** and are **not included in any minimum lease calculations**.

A contingent rent according to HKAS 17 is ‘that **part of the rent 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**.’

Thus in this case, Holcombe would recognise operating rentals of $5 million in year 1, $5 million in year 2 plus the inflation adjustment at the beginning of year 2, and $5 million in year 3 plus the inflation adjustment at the beginning of year 2 plus inflation adjustment at the beginning of year 3. **Based on current inflation, the rent will be $5·2 million in year 2 and $5·408 million in year 3**.

**Answer 7**

**(a)**

Purchase option regarding classification of the lease by SRC

According to HKAS 17.10, if the lessee (SRC) 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, it would normally lead to a lease being classified as a finance lease.

The option price is $10,000. In view of the fact that SRC estimated the economic useful life of the leased equipment to be eight years while the lease term is just five years, plus the fair value of the leased equipment at 1 January 20X7 is $227,500, it is reasonable to expect that the option price is sufficiently lower than the then fair value after five years. Therefore, SRC should classify the lease as a finance lease.

**(b)**

12.93% is the implicit rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payment and the unguaranteed residual value to be equal to the fair value of the leased asset:

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**(c)**



**Answer 8**

**(a)(i)**

The lease of Machine A is considered as an operating lease to QML as:

There is no transfer of ownership of Machine A nor option to purchase the machine by QML throughout the lease period or at the end of the lease.

The lease term of 6 years is not for the major part of the economic life of Machine A, i.e. 15 years.

The total gross rental over the lease term is [(HK$18,000 x12) x 6] + HK$200,000 = HK$1,496,000.

The present value of the above minimum lease payment amounts is not substantively all of the fair value of the leased asset, i.e. HK$3,500,000.

QML has no rights to continue the lease for a secondary period at a rent that is substantially lower than the market rent.

**(a)(ii)**

The lease of Machine B is considered as a finance lease to QML as:

QML has the option to purchase the asset at the end of the lease term at a price, i.e. HK$1,000 which is expected to be sufficiently lower than the fair value, i.e.HK$20,000 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.

The lease term of 4 years is for the major part of the economic life of the Machine B, i.e. 5 years.

The total gross rental over the lease term is [(HK$20,000 x12) x 4] = HK$960,000. The present value of the above minimum lease payment amounts is substantively all of the fair value of the leased asset, i.e. HK$920,000.

The lease is non-cancellable so that QML cannot reduce the minimum lease payment and cancellation is unlikely to occur.

**(b)(i)**

The lease of Machine C is considered as an operating lease to QML as:

There is no transfer of ownership of Machine C nor option to purchase the machine by QML throughout the lease period or at the end of the lease.

The lease term of 5 years is not for the major part of the economic life of Machine C, i.e. 20 years.

The total gross rental over the lease term is [(HK$25,000 x12) x 5] = HK$1,500,000. The present value of the above minimum lease payment amounts is not substantively all of the fair value of the leased asset, i.e. HK$5,000,000.

The lease is cancellable with two months’ notice and the penalty is only HK$50,000 which may increase the likelihood of cancellation if QML likes to terminate the lease early and reduce the minimum lease payment.

**(b)(ii)**

QML has recognised all the rental payments under the lease of Machine C as an asset and a liability at the inception of the lease in prior years. However, given the lease is an operating lease, such overstatements of both asset and liability in prior years are considered as an error.

Under HKAS 8.42, QML shall correct the material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

(a) restating the comparative amounts for the prior period presented i.e. the statement of financial position as at 31 December 2013 and the statement of profit or loss and other comprehensive income for the year ended 31 December 2013 if the error has occurred during the year ended 31 December 2013; or

(b) for the errors occurred before the earliest prior period presented, i.e.1 January 2013, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

QML shall present a third statement of financial position as at the beginning of the preceding period when the retrospective restatement has a material effect on the information in the statement of financial position at the beginning of the preceding period.

Accordingly, the financial statements of QML for the year ended 31 December 2014 include three statements of financial position as at 1 January 2013, 31 December 2013 and 31 December 2014.

QML should also disclose the information required by HKAS 1.41 to HKAS 1.44 and HKAS 8. However, the related notes for the opening statement of financial position as at 1 January 2013 are not required.