# Chapter 6 HKAS 17 Leases

**Topic List**

 **Page**

**1. Nature and Classification of leases**

1.1 Nature of leases 101

1.2 Classification of leases 101

**2. Accounting Treatment for Finance Lease**

2.1 In lessee’s book 107

2.2 In lessor’s book 113

**3. Accounting for Operating Lease**

3.1 In lessee’s book 116

3.2 In lessor’s book 117

3.3 Effects of leases 118

**4. Sale and Leaseback Transactions**

4.1 Introduction 120

4.2 Operating lease 121

4.3 Finance lease 125

**5. Current Issue** 127

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| **LEARNING OBJECTIVES**1. Explain the nature and classification of leases.2. Demonstrate awareness of the accounting issues concerned with expensing versus capitalizing for leases.3. Apply the required accounting treatment to operating leases and finance leases in the financial statements of the lessee (customer) and lessor (seller).4. Describe the disclosure requirements under HKAS 17 for both lessees (承租人) and lessors(出租人).5. Account for sale and leaseback transactions. |



**1. Nature and Classification of Leases**

**1.1 Nature of leases**

1.1.1 A leasing agreement is essentially a hiring agreement, in which ownership of an asset may never pass to the lessee. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals.

1.1.2 If the contract includes an option giving the lessee to purchase title to the asset upon the fulfillment of agreed conditions, the transaction is sometimes known as a hire purchase contract.

1.1.3 Leasing has been growing rapidly as a means of financing the acquisition of fixed assets where depreciation (capital) allowance is available for tax purpose. Reasons for entering leasing transaction are:

(i) Off-balance sheet financing (不入帳的融資)

In the past, under leasing, the asset remains the property of the lessor and is rented by the lessee. The lessee does not record the transaction in the balance sheet, and therefore the gearing ratio of the lessee company is not affected.

(ii) Tax allowances

A company is permitted to deduct some of the cost of the new assets from the taxable profits of the period of acquisition and gain the benefit of depreciation allowance during its economic useful life, thus reducing the tax payable and improving cash flow.

1.1.4 By issuing HKAS 17, the standard is trying to:

(i) **standardize the accounting procedures and reporting disclosure** used where leases are involved, which aids the financial statement comparability.

(ii) **prevent off-balance sheet financing** by requiring that the substance of transactions (rather than legal form) is reflected in the financial statements.

**1.2 Classification of leases**

(a) Classification

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| 1.2.1 | Definition |
|  | HKAS 17 defines a lease as 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. |

1.2.2 The Standard recognizes two types of lease – finance leases and operating leases.

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| 1.2.3 | Definitions |
|  | (a) Finance lease (融资租赁) – is a lease that transfer substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred. (是指實質上轉移與資産所有權有關的全部的風險和報酬的租賃。其所有權最終可能轉移也可能不轉移。)(b) **Operating lease –** is a lease **other than a finance lease.** The lessee pays rental for the hire of an asset for a period of time which is normally substantially less than its useful economic life. The **lessor retains most of the risks and rewards of ownership of the asset**. |

1.2.4 Under HKAS 17, for a lease of both land buildings, the **land and buildings elements are considered separately** for the purpose of lease classification, **unless** title to **both elements** is expected to **pass to the lessee by the end of the lease term**.

1.2.5 HKAS 17 emphasises that an **important consideration for land is its indefinite economic life**. It requires that a **lease of land is classified** **in accordance with the normal lease classification criteria as that for all other leases**.



(b) Risks and rewards of ownership

1.2.6 **Risks** may be represented by the possibility of:

(i) losses from idle capacity or technological obsolescence;

(ii) variations in return due to changing economic conditions.

1.2.7 **Rewards** may be represented by the expectation of:

(i) profitable operation over the asset’s economic life;

(ii) gain from appreciation in value or realisation of residual value.

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| 1.2.8 | Example 1 |
|  | User leased a specialized piece of equipment on 1 October 2016. The lessor agreed to buy a particular item to User’s detailed specification for User’s choice of supplier. The items has an expected useful life of up to 10 years, but the lease agreement will terminate at the end of 8 years, at which times the asset will be returned to the lessor.The lease agreement makes User responsible for any damage to the equipment, either accidental or through poor maintenance. The lessor will not be responsible for any loss of use arising because of breakdowns.User’s Chief Accountant has declared that she does not need to see any detailed figures in order to classify this lease. The broad description of the lease terms and conditions indicates that it is almost certainly a finance lease.**Required:**Explain whether User’s lease appears to be a finance lease.**Solution:**Whether or not a lease passes substantially all the risks and rewards of ownership will be **evident from the terms of the lease contract and an understanding of the commercial risks** undertaken by each party. HKAS 17 provides guidance in cases where there may be doubt.In the case of User, the lease is almost certainly a finance lease.* User has the use of the asset for the period in which substantially all the benefits will be derived from the asset.
* The equipment was purchased to User’s detailed specification, and from User’s choice of supplier. It is unlikely that, once the asset transfers back to the lessor, the lessor would be easily able to trade it in.
* User has also agreed to bear almost all of the risks of ownership, since it is expected to be responsible for any damage to the equipment, and for any loss of use arising through breakdowns. This indicates that the leasing company is acting as a finance lender to User, rather than as a lender of one of its own assets.
 |

(c) Minimum lease payments (最低租赁付款额)

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| --- | --- |
| 1.2.9 | Definition |
|  | **Minimum lease payments** is the payments over the lease term that the lessee is, or can be required, to make (excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor), together with:(a) in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee;(b) in the case of the lessor, any residual value guaranteed to the lessor by one of the following:(i) the lessee(ii) a party related to the lessee(iii) an independent third party financially capable of meeting this guarantee |

1.2.10 **Contingent rent (或有租金)** is that portion of the lease payments that is **not fixed** in amount but is based on a factor other than just the passage of time (for example, percentage of sales, amount of usage, price indices, market rates of interest).

1.2.11 **Contingent rent** is **charged as expenses in the periods** in which it is **incurred**.

1.2.12 To decide whether there is a presumption of transfer of risks and rewards of ownership, it is necessary to consider the following:

|  |  |
| --- | --- |
| **Step** | **Comments** |
| (1) Calculate minimum lease payments (MLPs) inclusive of initial payment | MLPs = **minimum payment plus any residual amounts guaranteed by the lessee** |
| (2) Discount (1) to determine present value of MLPs | Discount factor is either:(i) rate of interest implicit in the lease (if known); or(ii) a commercial rate of interest (for a similar lease) |
| (3) Calculate fair value of the asset at beginning of lease | Fair value = arm’s length price (公平價格) |
| (4) It is a finance lease if the present value of MLPs is equal to substantially all the fair value (**90% or more of (3)**) |  |

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| 1.2.13 | Example 2 - MLP |
|  | A manufacturing company has been analyzing proposals for the lease or purchase of a major acquisition of new equipment. The lease proposal was considered to be more reliable. The following information is relevant:(i) The proposed lease agreement involves an equipment that has a fair value of $600,000.(ii) The lease period is for four year from 1 January 2015 with a rental of $200,000 per annum payable on the 31 December each year from 31 December 2015.(iii) The lessee guarantees a $20,000 residual value on 31 December 2018.(iv) The lessee is required to pay all repair, maintenance and insurance costs as they arise.(v) The interest rate implicit in the lease is 15% per annum.**Solution:**To clarify the transaction, we have:(i) Minimum lease payments = 4 × $200,000 + $20,000 = $820,000(ii) Present value of minimum lease payments$200,000 × 2.855\* + $20,000 ×  = $582,435\* From annuity tables – present value of four annual sums at 15% interest rate per annum is 2.855(iii) Fair value of assets is $600,000At present value of the minimum lease payments ($582,435) is substantial equal to all the fair value of the asset ($600,000), being 97.1% of the fair value, the transaction is a “finance lease” since it can be concluded that substantially all the risks and rewards incident to ownership of the asset has been transferred to the lessee. |

(d) Indicators

1.2.14 HKAS 17 lists the following as **examples** of situations where a lease would normally be **classified as a finance lease**:

(i) **ownership is transferred** to the lessee **at the end** of the lease;

(ii) the lessee has the **option to purchase** the asset at a **bargain price** and it seems likely that, at the inception of the lease, this **option will be exercised**;

(iii) the lease term is for the **major part of the useful life** of the asset; and at the inception of the lease, the present value of the minimum lease payments is greater than, or equal to substantially all of, the fair value of the leased asset; (租赁期占租赁资产使用寿命的大部分。这里的“大部分”掌握在租赁期占租赁开始日租赁资产使用寿命的75%以上。)

(iv) if the **lessee can cancel the lease any losses** **associated with the cancellation** are **borne by the lessee**;

(v) **gains or losses from the fluctuation in the fair value** of the **residual fall to the lessee** (e.g. in the form of a rent rebate equaling most of the sales proceeds at the end of the lease);

(vi) the lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent; and

(vii) the leased assets are of a **specialised nature (性质特殊)** such that only the lessee can use them without major modifications being made.

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| Question 1 |
| A company has entered into a four year lease for a machine, with lease rentals of $150,000 payable annually in advance, and with an optional secondary period of three years at rentals of 80%, 60% and 40% of the annual rental in the primary period. It is agreed that these rentals represent a fair commercial rate. The machine has a useful life of eight years and a cash value of $600,000.**Required:**Consider whether this lease agreement is a finance lease or an operating lease? |

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| **Solution:** |

(e) Terms of lease

1.2.15 The status of the lease may often be determined from an examination of the lease terms. A transference of risks and rewards is assumed if:

(i) the lessee has the use of the asset for most of its useful economic life;

(ii) the lessee bears the cost normally associated with ownership (e.g. insurance, maintenance, idle capacity);

(iii) the present value of the amounts guaranteed by the lessee is materially equivalent to the cost of purchase;

(iv) any amounts accruing to the lessor at the end of the lease are relatively small.

(f) Initial direct costs

1.2.16 Lessors should **include initial direct costs** (e.g. legal fee) incurred in negotiating a lease in the initial measurement of finance lease receivables. They are therefore spread over the lease term on the same basis as the lease income.

1.2.17 This treatment **does not apply to manufacturer or dealer** lessors where **such cost** recognition is **as an expense** when the selling profit is recognized.

1.2.18 Any **initial direct costs of the lessee** in a finance lease are **added to the amount recognized as an asset**.

**2. Accounting Treatment for Finance Lease**

**2.1 In lessee’s book**

(a) Initial entries

2.1.1 HKAS 17 requires that finance leases must be **capitalized**. A finance lease should be shown in the lessee’s statement of financial position both as an asset and as a liability. At the start of the lease:

(a) the leased asset should be included as a non-current asset, subject to depreciation;

(b) the obligation to pay rentals should be included as a liability.

2.1.2 At the inception of the lease, the amounts will **equal the lower of**:

(i) the **fair value** of the leased property; **and**

(ii) the **present value of the minimum lease payments**.

2.1.3 However, **in practice the fair value** of the asset or its cash price will **usually be the recorded amount**, rather than the present value of the minimum lease payments.

(b) Depreciation

2.1.4 If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset.

2.1.5 Otherwise, the related non-current asset should be **depreciated over the shorter of**:

(a) the **economic useful life** of the asset; **and**

(b) the **lease term**.



2.1.6 The lease term is essentially the period over which the lessee is likely to have use of the asset. It **includes**:

(a) the **primary** (non-cancellable) period; **plus**

(b) any **secondary periods** during which the lessee has the contractual right to continue to use the asset, provided that it is reasonably certain at the outset that this right will be exercised.

(c) Allocation of finance charge

2.1.7 Over the period of the lease, the total finance charge is the amount by which the rentals paid to the lessor exceed the initial recorded amount.

2.1.8 Each individual **rental payment** should be **spilt** between:

(i) finance charge (income statement item); and

(ii) repayment of obligation to pay rentals (thus reducing the balance sheet liability).

2.1.9 There are three main methods to allocate the finance charges over the term of the lease:

(i) actuarial method (精算方法);

(ii) sum of the digits (rule of 78) method (年數累計法);

(iii) straight-line method (but generally not acceptable).

Of the above methods the actuarial method gives the most accurate result.



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| 2.1.10 | Example 3 – Actuarial method |
|  | A company has two options. It can buy an asset for cash at a cost of $5,710 or it can lease it by way of a finance lease. The terms of the lease are as follows:(1) primary period is for four years from 1 January 2015 with a rental of $2,000 p.a. payable on the 31 December each year;(2) the lessee has the right to continue to lease the asset after the end of the primary period for an indefinite period, subject only to a nominal rent;(3) the lessee is required to pay all repair, maintenance and insurance costs as they arise;(4) the interest rate implicit in the lease is 15%.The lessee estimates the useful economic life of the asset to be eight years. Depreciation is provided on a straight-line basis.**Solution:**Step 1We may check to confirm whether the lease is a finance lease by comparing the present value of the MLPs with the cash price.The interest rate implicit in the lease is the rate at which the payments made under the lease must be discounted to make them equal to the initial cost. In this case the rate is 15%, as the following calculation shows:

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Payment | Discount factor at 15% | Net present value |
|  | $ |  | $ |
| 2015 | 2,000 | 0.870 | 1,740 |
| 2016 | 2,000 | 0.756 | 1,512 |
| 2017 | 2,000 | 0.657 | 1,314 |
| 2018 | 2,000 | 0.572 | 1,144 |
|  | Present value of MLPs | 5,710 |

Step 2The asset is shown as a non-current asset in the statement of financial position at $5,710 (subject to depreciation).Depreciation is over eight years (presumably no residual value to the asset at the end of eight years)Annual depreciation charge = 1/8 × $5,710 = $714Step 3The liability is shown in the balance sheet at $5,710 but subsequently reduced by the capital portion of the leasing payments.The total finance charge is $(8,000 – 5,710) = $2,290. The allocation of this to each rental payment and the consequent capital sum outstanding is calculated as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 |
| Period (year ended 31 Dec) | Capital sum at start of period | Finance charge at 15% pa | Sub-total | Rental paid | Capital sum at the end of period |
|  | $ | $ | $ | $ | $ |
| 2015 | 5,710 | 856 | 6,566 | (2,000) | 4,566 |
| 2016 | 4,566 | 685 | 5,251 | (2,000) | 3,251 |
| 2017 | 3,251 | 488 | 3,739 | (2,000) | 1,739 |
| 2018 | 1,739 | 261 | 2,000 | (2,000) | - |
|  |  | 2,290 |  | 8,000 |  |

Step 4The effect on the financial statements of the lessee may be summarized as follows:

|  |  |
| --- | --- |
| **Income Statement** | **Statement of financial position** |
| Year ended 31 Dec | Finance charge | Depn | Non-current asset (NBV) | Obligation |
|  |  |  |  | Total | Non-current | Current |
|  | $ | $ | $ | $ | $ | $ |
| 2015 | 856 | 714 | 4,996 | 4,566 | 3,251 | 1,315 |
| 2016 | 685 | 714 | 4,282 | 3,251 | 1,739 | 1,512 |
| 2017 | 488 | 714 | 3,568 | 1,739 |  | 1,739 |
| 2018 | 261 | 714 | 2,854 |  |  |  |
| 2019 | - | 714 | 2,140 |  |  |  |
| 2020 | - | 714 | 1,426 |  |  |  |
| 2021 | - | 714 | 712 |  |  |  |
| 2022 | - | 712 | - |  |  |  |
|  | 2,290 | 5,710 |  |  |  |  |

The format in step 3 will be used whenever the payments under a lease are made **in arrears**. If the payments are due **in advance**, the rental paid is deducted from the capital sum at the start of the period before the interest is calculated. In other words, columns 3 and 5 would be reversed. |

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| Question 2 |
| P Limited entered into a five-year lease on 1 January 2015 for a machine with a fair value of $20,000. Rentals are $5,200 p.a. payable in advance and the residual value at the end of the lease is calculated as $4,200 which will be returned to P Limited.P Limited is responsible for insurance and maintenance costs. The rate of interest implicit in the lease is 15.15%.**Required:**Show the allocation of the finance charges over the lease term on an actuarial basis and calculate the non-current liability for finance lease at 31 December 2015. |

|  |
| --- |
| **Solution:** |

|  |  |
| --- | --- |
| 2.1.11 | Example 4 – Sum of digit method (rule of 78) |
|  | ABC Ltd enters into a lease contract for a plant with XYZ Ltd which is non-cancellable with a primary term of five years from 1 January 2015. The rental is $2,600 per year payable in advance. ABC Ltd is required to pay all the maintenance and insurance costs related to the asset as they arise. The leased asset could have been purchased at the start of the lease at $10,000. The carrying amount of the asset in XYZ Ltd’s books is $4,800. The company uses the “Rule of 78” method for allocation of finance charge and straight line method for calculating depreciation charge.**Solution:****Step 1**Check whether it is finance lease or not. The question does not mention the implicit interest rate, we cannot calculate the present value of MLPs. However, it is because the lessee is required to pay all the maintenance and insurance costs, all the risks and rewards of ownership of the asset have been transferred substantially to the lessee. As a result, it is a finance lessee.Step 2The asset is shown in the statement of financial position at $10,000 (subject to depreciation).Depreciation is over five yearsAnnual depreciation charge = 1/5 × $10,000 = $2,000Step 3Allocation of finance charge

|  |  |
| --- | --- |
|  | $ |
| Total rentals ($2,600 × 5) | 13,000 |
| Less: Cash price of fixed assets | 10,000 |
| Finance charge | 3,000 |

Rule of 78 (or sum of the digits method)

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Digits | Proportion allocated | Finance charge |
|  |  |  | $ |
| 2015 | 4 | 4/10 | 1,200 |
| 2016 | 3 | 3/10 | 900 |
| 2017 | 2 | 2/10 | 600 |
| 2018 | 1 | 1/10 | 300 |
|  | 10 |  | 3,000 |

Payment schedule

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 |
| Year | Principal | Repayment | Principal outstanding | Finance charge | Balance c/f |
|  | $ | $ | $ | $ | $ |
| 2015 | 10,000 | 2,600 | 7,400 | 1,200 | 8,600 |
| 2016 | 8,600 | 2,600 | 6,000 | 900 | 6,900 |
| 2017 | 6,900 | 2,600 | 4,300 | 600 | 4,900 |
| 2018 | 4,900 | 2,600 | 2,300 | 300 | 2,600 |
| 2019 | 2,600 | 2,600 | - | - | - |
|  |  | 13,000 |  | 3,000 |  |

Step 4Accounting entries:

|  |  |  |
| --- | --- | --- |
|  | Dr. ($) | Cr. ($) |
| 1. Non-current assets – Plant | 10,000 |  |
| Lease liability |  | 10,000 |
|  |  |  |
| 2. Finance charges | 1,200 |  |
| Lease liability | 1,400 |  |
| Bank |  | 2,600 |
|  |  |  |
| 3. Depreciation | 2,000 |  |
| Accumulated depreciation |  | 2,000 |

 |

 (d) Disclosure requirements by lessee

2.1.12 In the statement of financial position, the transaction should be recorded as follows:

(i) Assets – show by each major class of asset the net carrying amounts of assets held under finance leases;

(ii) Obligations – the amount should be disclosed separately from other liabilities on the face of the statement of financial position or in a note and obligations under finance leases should be analysed into:

(a) amount payable in the **next year**;

(b) amount payable in the **second to fifth years** inclusive from the statement of financial position date; and

(c) the aggregate amounts payable **thereafter**.

2.1.13 In the statement of comprehensive income, the total finance charges for the period and depreciation for each major class of asset for finance leases are reported.

|  |  |
| --- | --- |
| 2.1.14 | Example 5 - Disclosure |
|  | From Example 4, extract from the statement of financial position as at 31 December 2015 would be:

|  |  |
| --- | --- |
|  | $ |
| Non-current assets |  |
| Plant held on finance lease (net book value) | 8,000 |
|  |  |
| Current liabilities |  |
| Obligations under finance lease $(8,600 – 6,000) | 2,600 |
|  |  |
| Non-current liabilities |  |
| Obligations under finance leases | 6,000 |
|  |  |
| **Notes to the accounts (extract)** |  |
|  |  |
| (1) Profit from operations is arrived at after charging: |  |
|  |  |
| Depreciation on assets held under finance leases – Plant | 2,000 |
| Finance cost – Finance charges on leased assets | 1,200 |
|  |  |

(2) Assets held under finance leases

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cost | Accumulated depreciation | Net book value |
|  | $ | $ | $ |
| Plant | 10,000 | 2,000 | 8,000 |

(3) Obligations under non-cancellable finance leases

|  |  |
| --- | --- |
|  | $ |
| Payable in next year | 2,600 |
| Payable in two to five years | 7,800 |
|  | 10,400 |
| Less: finance charges allocated to future periods | (1,800) |
|  | 8,600 |
| Less: current portion | (2,600) |
| Non-current portion | 6,000 |

 |

**2.2 In lessor’s book**

(a) Finance income determination

2.2.1 Lessor should record a finance lease as a debtor in the balance sheet at its net investment amount, i.e. initially this debtor is valued at **gross investment in the lease** – (**MLPs plus unguaranteed residual value**) **less unearned finance income**.

|  |  |
| --- | --- |
| 2.2.2 | Example 6 |
|  | The fact is same as example 4. Calculate the net investment and finance income for each of the year of the contract. Assume residual value to be nil.**Solution:**1. Calculation of interest rates (using annuities tables):Cash price = $10,000Initial payment = $2,600Amount advanced = $7,400 to be repaid over four years(a) By present value concept, the following formula can be made:(b) Divide $7,400 by $2,600 = 2.8462(c) From annuity table for four years, interest rate is between 15% to 16%.(d) From the table, difference between 15% and 16% is 0.0568.

|  |  |  |
| --- | --- | --- |
| 15% | : | 2.8550 |
| 16% | : | 2.7982 |
| Difference | : | 0.0568 |

(e) Using linear interpolation method to determine interest rate:Interest rate = 15% + (0.0088/0.0568)% = 15.15%Hence, interest rate would be 15.15% or prevailing commercial rate for a similar lease.2. Repayment schedule

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 |
| Year | Open net investment | Installment received | Period net investment | Finance income | Closing net investment |
|  |  |  |  | (15.15%) |  |
|  | $ | $ | $ | $ | $ |
| 2012 | 10,000 | 2,600 | 7,400 | 1,121 | 8,521 |
| 2013 | 8,521 | 2,600 | 5,921 | 897 | 6,818 |
| 2014 | 6,818 | 2,600 | 4,218 | 639 | 4,857 |
| 2015 | 4,859 | 2,600 | 2,257 | 343 | 2,600 |
| 2016 | 2,600 | 2,600 | - | - | - |
|  |  | 13,000 |  | 3,000 |  |

3. Accounting entries

|  |  |  |
| --- | --- | --- |
|  | Dr. ($) | Cr. ($) |
| 1. Lease receivable | 10,000 |  |
| Cost of goods sold | 4,800 |  |
| Sales |  | 10,000 |
| Inventory |  | 4,800 |
|  |  |  |
| 2. Cash | 2,600 |  |
| Lease receivable |  | 1,479 |
| Finance income – income statement |  | 1,121 |

 |

2.2.3 If the lessor is a manufacturer or dealer, under finance lease, he should:

(i) recognize the selling profit/loss in income for the period as if it was an outright sale.

(ii) restrict any selling profit on a finance lease to the excess of the fair value over the cost of the asset, i.e. $10,000 – $4,800 = $5,200. Note that in this case the accounting policy is to recognize the whole profit in full immediately.

2.2.4 If it is under an operating lease, the manufacturer or dealer should not recognize any selling profit because it is not the equivalent of a sale. He has retained the assets with a view to using them to generate rental income.

(b) Disclosure requirements by lessor

2.2.5 In the statement of financial position, disclosure is required for net investment in finance leases, analysed into:

(i) amounts receivable in the next year;

(ii) amounts receivable in the second to fifth years inclusive from the balance sheet date; and

(iii) the aggregate amounts receivable thereafter.

2.2.6 In the statement of comprehensive income, it is required to report finance income earned under finance leases.

|  |  |
| --- | --- |
| 2.2.7 | Example 7 |
|  | Using the information in Example 5, the extract statement of financial position as at 31 December 2015 would be:

|  |  |
| --- | --- |
|  | $ |
| Non-current assets |  |
| Other financial assets |  |
| Net investment in finance leases[3 × $2,600 – $897 – $639 – $343] | 5,921 |
|  |  |
| Current assets |  |
| ReceivablesNet investment in finance leases ($8,521 – $5,921) | 2,600 |

|  |  |
| --- | --- |
| **Notes to the accounts (extract)** |  |
|  |  |
| 1. Interest earned from financed leases | 1,121 |
| 2. Net investment in finance leases |  |
| Receivable in next year | 2,600 |
| Receivable in two to five years | 7,800 |
|  | 10,400 |
| Less: finance income related to future periods | (1,879) |
|  | 8,521 |
| Less: current portion | (2,600) |
| Non-current term portion | 5,921 |

 |

**3. Accounting for Operating Lease**

**3.1 In Lessee’s books**

|  |  |
| --- | --- |
| 3.1.1 | Key points |
|  | (a) The lessee will not recognize an asset held under an operating lease.(b) The lease payments will be charged to the statement of comprehensive income on a straight-line basis, unless a preferable alternative basis exists.(c) Any difference between amounts charged and amounts paid should be adjusted to prepayments or accruals.(d) Any incentives given by the lessor should also be recognized over the life of the lease on a straight line basis. Typical incentives include rent-free periods, or contributions by the lessor to the lessee’s relocation costs. |

|  |  |
| --- | --- |
| 3.1.2 | Example 8 |
|  | VWX Ltd is the lessor of plant which it acquired at a cost of $400,000 on 1 January 2015. This plant, which has an estimated life of 10 years with no residual value, was leased on that same day for an initial period of five years to RST Ltd, at an annual rental of $60,000.**Solution:**Extract from statement of comprehensive income for the year ended 31 December 2015

|  |  |
| --- | --- |
|  | $ |
| Operating lease rentals | 60,000 |
|  |  |
| Notes to the accounts (extract) |  |
| 1. Profit from operations is arrived at after charging: |  |
| Operating lease rentals in respect of a plant | 60,000 |
| 2. Commitments under non-cancellable operating leases for a plant |  |
| Expiring in two to five years | 240,000 |

 |

|  |
| --- |
| Question 3 |
| Boro plc has moved into new premises. The premises are on a ten-year operating lease at a rent of $1m per annum, payable in advance on 1 January each year. The landlord was keen to rent out the property, and so Boro has been given $200,000 up front to cover relocation costs, and the first year’s rent has been waived.**Required:**(a) Calculate the annual rent that will be charged to the income statement.(b) Calculate the accruals/prepayments that will appear in the statement of financial position at the end of each year of the lease.(c) Prepare the disclosure notes as at the end of Year 1. |

|  |
| --- |
| **Solution:** |

**3.2 In lessor’s book**

|  |  |
| --- | --- |
| 3.2.1 | Key points |
|  | (a) Assets held for use in operating leases should be **treated as non-current assets** **and depreciated** accordingly. **Rentals** should be **recognized on a straight line basis** over the period of the lease unless a preferable alternative basis exists.(b) In the statement of financial position, gross assets held for operating leases, analysed by major class of asset, together with the related accumulated depreciation need to be disclosed.(c) Any difference between amounts charged and amounts paid should be adjusted to **receivables or deferred income**.(d) The **initial direct costs** of the lease may be **spread over the life of the lease** **or charged when incurred**.(e) In the notes to the statement of financial position, the future minimum lease payments under non-cancellable operating leases analysed among those expiring in the next year, in two to five years, and in more than five years.(f) In the income statement, rentals receivable from operating leases should be reported. |

|  |  |
| --- | --- |
| 3.2.2 | Example 9 - Disclosure |
|  | Using the information in Example 8, the disclosure is shown below:

|  |
| --- |
| **Extract from income statement for year ended 31 December 2015** |
|  | $ |
| Turnover (leasing rental) | 60,000 |
| Cost of sales (depreciated based on useful life – 10% × $400,000) | 40,000 |
|  |  |
| **Extract from statement of financial position as at 31 December 2015** |  |
|  |  |
| Non-current assets |  |
| Plant and machinery | 280,000 |
|  |  |
| **Notes to the accounts (extract)** |  |
|  |  |
| 1. Profit from operations is arrived at after crediting: |  |
| Operating lease rentals received | 60,000 |
|  |  |
| 2. Plant held for leasing: |  |
| Cost | 400,000 |
| Less: accumulated depreciation | 120,000 |
|  | 280,000 |
| 3. Payments receivable under non-cancellable operating leases for a plant |  |
| Expiring in two to five years | 120,000 |

 |

**3.3 Effects of leases**

3.3.1 The significance of the accounting treatment of leased assets is heightened by the difference between the accounting treatment of finance leases and that of operating leases which are summarised as follows:

|  |  |
| --- | --- |
| **Finance lease** | **Operating lease** |
| Asset capitalized | No asset |
| Liability recognized | No liability |
| Finance charge | Full rental charge |
| Depreciation charge | No depreciation |

|  |  |
| --- | --- |
| 3.3.2 | Key points |
|  | If a finance lease asset is **incorrectly treated** as an operating lease it will have the following effects on the financial statements:* assets understated – return on capital employed overstated
* liabilities understated – gearing understated
* little effect on income statement.
 |

|  |
| --- |
| Question 4 |
| Oroc Ltd hires out industrial plant on long-term operating lease. On 1 January 2015 it entered into a seven-year lease on a mobile crane. The terms of the lease are $175,000 payable on 1 January 2015, followed by six rentals of $70,000 paid on 1 January 2016 to 2021. The crane will be returned to Oroc on 31 December 2021. The crane cost $880,000 and has a 25-year useful life with no residual value.**Required:**(a) Calculate the annual rental income that will be claimed by Oroc Ltd.(b) Prepare extracts from the income statement and statement of financial position of Oroc Ltd for 2015 and 2016.(c) Prepare the disclosure notes as at the end of 2015 and 2016. |

|  |
| --- |
| **Solution:** |

|  |
| --- |
| **Question 5**The manufacturing property of the group, other than the head office, was held on an operating lease over 8 years. On re-organisation on 31 October 2007, the lease has been renegotiated and is held for 12 years at a rent of $5 million per annum paid in arrears. The fair value of the property is $35 million and its remaining economic life is 13 years. The lease relates to the buildings and not the land. The factor to be used for an annuity at 10% for 12 years is 6·8137. (5 marks)The directors are worried about the impact that the above changes will have on the value of its non-current assets and its key performance indicator which is ‘Return on Capital Employed’ (ROCE). ROCE is defined as operating profit before interest and tax divided by share capital, other reserves and retained earnings. The directors have calculated ROCE as $30 million divided by $220 million, i.e. 13·6% before any adjustments required by the above.**Required:**Discuss the accounting treatment of the above transactions and the impact that the resulting adjustments to the financial statements would have on ROCE.Note: your answer should include appropriate calculations where necessary and a discussion of the accounting principles involved. (ACCA P2 Corporate Reporting December 2007 Q3(d)) |

**4. Sale and Leaseback Transactions (售後租回)**

**4.1 Introduction**

4.1.1 A sale and leaseback transaction takes place when **an owner sells an asset and immediately reacquires the right to use the asset by entering into a lease with the purchaser**. A common example is a company selling the title to its office/ factory to a financial institution.

4.1.2 Before dealing with the accounting for the sale and leaseback transaction itself, the carrying value of the asset in question should be reviewed. If the asset has suffered an impairment in value below its carrying amount it should be written down immediately to its fair value.

4.1.3 The subsequent steps will depend on whether the leaseback is an operating lease or a finance lease. If the asset is land and buildings then it is likely to be an operating lease.

**4.2 Operating lease**

|  |  |
| --- | --- |
| 4.2.1 | Key point |
|  | If the leaseback is an operating lease, the seller-lessee has disposed of substantially all the risks and rewards of ownership of the asset and so has realized a profit or loss on the disposal. |

4.2.2 Provided that the transaction is established at fair value, the profit or loss should be recognized immediately.

(a) Proceeds above fair value

4.2.3 However, it is possible that a sale and leaseback transaction can be arranged at other than fair value. If the price is **above** fair value, the excess will not be genuine profit, but will arise solely because the operating lease rentals payable in the ensuring years will also be at above fair value.

4.2.4 HKAS 17 therefore provides that the **excess of sale price over fair value** should **not** be **recognized as profit in the year** but should be **credited to income**, **over the period** for which **the asset is expected to be used**, so as to reduce the rentals payable to a level consistent with the fair value of the asset.

|  |  |
| --- | --- |
| 4.2.5 | Example 10 – The sale price is above fair value |
|  | Ash Ltd sells its freehold office premises and leases them back on a twenty-year operating lease. The sale took place on 1 January 2015, and the company has a 31 December year end.The details of the scheme are as follows:

|  |  |
| --- | --- |
|  | $ |
| Proceeds of sale | 10,000,000 |
|  |  |
| Fair value of the asset at the time of sale | 9,000,000 |
|  |  |
| Net book value at the time of sale | 3,500,000 |
|  |  |
| Lease payments | 480,000 |
|  |  |
| Market rate for similar premises | 410,000 |

In this example it is clear that the lessor is recouping the excess proceeds through an above market rent. This is common in practice. However, the accounting treatment set out below will be followed even if the rents are at market rate.**Required:**(a) Calculate the profit on disposal that Ash Ltd should claim in 2015.(b) Calculate the annual rental that Ash Ltd will charge in its statement of comprehensive income.(c) Prepare all relevant extracts from Ash Ltd’s statement of comprehensive income and statement of financial position for the year ended 31 December 2015.**Solution:**(a) Ash Ltd can only claim a profit on disposal based upon the fair value of the asset. This will give a profit on disposal of $5,500,000 ($9,000,000 fair value less $3,500,000 NBV)(b) The $1m difference between the proceeds and the fair value will be credited to deferred income and released over the life of the lease on a straight line basis. The annual release will be $50,000 ($1m ÷ 20 years). This reduces the rent charged to $430,000.(c) Statement of comprehensive income for 2015

|  |  |  |
| --- | --- | --- |
|  | $ | $ |
| Profit on disposal |  | 5,500,000 Cr |
| Operating lease rentals | 480,000 Dr |  |
| Less: release of deferred income | 50,000 Cr | 430,000 Dr |

(d) Statement of financial position as at 31 December 2015

|  |  |  |
| --- | --- | --- |
|  |  | $ |
| Deferred income | Brought forward | - |
|  | Arising during the year | 1,000,000 |
|  | Released to the income statement | (50,000) |
|  | Carried down | 950,000 |

$900,000 of this liability is non-current. |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Question 6**Holcombe also owns an office building with a remaining useful life of 30 years. The carrying amount of the building is $120 million and its fair value is $150 million. On 1 May 2009, Holcombe sells the building to Brook, a public limited company, for its fair value and leases it back for five years at an annual rental payable in arrears of $16 million on the last day of the financial year (30 April). This is a fair market rental. Holcombe’s incremental borrowing rate is 8%.On 1 May 2009, Holcombe has also entered into a short operating lease agreement to lease another building. The lease will last for three years and is currently $5 million per annum. However an inflation adjustment will be made at the conclusion of leasing years 1 and 2. Currently inflation is 4% per annum.The following discount factors are relevant (8%).

|  |  |  |
| --- | --- | --- |
|  | **Single cash flow** | **Annuity** |
| Year 1 | 0.926 | 0.926 |
| Year 2 | 0.857 | 1.783 |
| Year 3 | 0.794 | 2.577 |
| Year 4 | 0.735 | 3.312 |
| Year 5 | 0.681 | 3.993 |

**Required:**(i) Show the accounting entries in the year of the sale and lease back assuming that the operating lease is recognised as an asset in the statement of financial position of Holcombe; (6 marks)(ii) State how the inflation adjustment on the short term operating lease should be dealt with in the financial statements of Holcombe. (3 marks) (ACCA P2 Corporate Reporting June 2010 Q4(b)) |

(b) Proceeds below fair value

4.2.6 If a loss on disposal arises because the proceeds are less than the fair value of the asset, then the **loss can only be deferred** **if the future operating lease rentals are also at below the market rate**. This is because deferring a loss gives rise to an asset in the statement of financial position, and assets can only be recognized if there are future economic benefits. The economic benefits that will justify deferring this loss are reduced rentals.

4.2.7 The following example will look at two situations in respect of the operating lease:

(a) the rentals are at (or above) the market rate

(b) the rentals are below the market rate

|  |  |
| --- | --- |
| 4.2.8 | Example 11 – The sale price is below fair value |
|  | On 1 January 2015 Crash Ltd sold its freehold office premises and leased them back on a 20-year operating lease. The details of the scheme are as follows:

|  |  |
| --- | --- |
|  | $ |
| Proceeds of sale | 8,000,000 |
|  |  |
| Fair value of the asset at the time of sale | 15,000,000 |
|  |  |
| Net book value at the time of sale | 12,000,000 |
|  |  |
| Annual operating lease rentals (on a 20-year lease) | 650,000 |

**Required:**Prepare all relevant extracts from Crash Ltd’s statement of comprehensive income and statement of financial position for the year ended 31 December 2015 assuming:(a) the future rentals are at market rate; and(b) the future rentals are at below market rate, and that the reduced rate will fully compensate Crash for the loss suffered on disposal.**Solution:**(a) Future rentals at market rateIf the rentals are at market rate (or above) then there are no future benefits to offset the loss on disposal, and so the loss must be recognized immediately.Statement of comprehensive income for the year ending 31 December 2015

|  |  |  |
| --- | --- | --- |
|  |  | $ |
| Loss on disposal | $8m proceeds less $12m NBV | 4,000,000 Dr |
| Operating lease rentals | Amount paid | 650,000 Dr |

There will be no asset carried forward in the statement of financial position.(b) Future rentals at below market rateIf the rentals are below market rate then the loss on disposal will give rise to the future benefits of cheap benefits. In this case the **loss can be deferred and amortised over the life of the lease**.Statement of comprehensive income for the year ending 31 December 2015

|  |  |  |
| --- | --- | --- |
|  | $ | $ |
| Loss on disposal – Deferred |  | Nil |
| Operating lease rentals |  |  |
| Amount paid | 650,000 |  |
| Plus: amortisation of deferred loss ($4m/20 years) | 200,000 |  |
| Amount charged to the income statement |  | 850,000 |

Statement of financial position as at 31 December 2015

|  |  |  |
| --- | --- | --- |
|  |  | $ |
| Assets |  |  |
| Deferred loss on disposal |  |  |
| Brought forward |  | - |
| Arising during the year |  | 4,000,000 |
| Amortised |  | (200,000) |
| Carried down |  | 3,800,000 |

$3,600,000 of this loss would be separately disclosed as being recoverable after more than 12 months. |

4.2.9 It would be wise to do regular impairment reviews on such assets, because changes in market rentals and/or interest rates could easily impair the benefit of the reduced rent.

4.2.10 If the proceeds are less than the fair value, and the fair value is less than the net book value, then only the difference between the proceeds and the fair value can be deferred. The difference between the fair value and the net book value must be recognized as a loss immediately.

4.2.11 For example, if a building with a carrying value of $9m and a fair value of $7m was sold for $4m, then a loss of $2m would be recognized on disposal, and the $3m difference between the proceeds and the fair value would be deferred.

**4.3 Finance lease**

4.3.1 If the **leaseback is a finance lease**, the seller-lessee is in effect re-acquiring substantially all the risks and rewards of ownership of the asset. In other words, he **never disposes of his ownership** interest in the asset, and so it would **not** be correct to **recognize a profit or loss** in relation to an asset which (in substance) never was disposed of.

4.3.2 Following on from this, the basic approach to a sale and finance-leaseback is as follows:

(a) the asset is **derecognized at its carrying amount** and then **reinstated at its fair value with any disposal gain**;

(b) **depreciated** over the **shorter of the lease term and useful life**;

(c) results in a **liability being created**;

(d) **finance charge** accruing at the implicit rate within the lease.

4.3.3 The treatment will not be affected by the proceeds being above or below the market value of the asset. The **asset** is only being **used as security for the loan**, and so it is up to the lender as to whether they are prepared to lend more or less than the value of the security. However, as a totally separate issue, the **process of valuing the asset may reveal an impairment or a potential revaluation**. These adjustments will be dealt with in the normal way and they do not affect the substance of the sale and leaseback transaction itself.

4.3.4 The subsequent lease payments will then be **treated in the normal way**, split between principal and interest.

|  |  |
| --- | --- |
| 4.3.5 | Example 12 |
|  | Lash Ltd has run short of cash, and so it has decided to sell an expensive item of machinery and lease it back on a five-year finance lease. The sale took place on 1 January 2015, and the company has a 31 December year end. The details of the scheme are as follows:

|  |  |  |
| --- | --- | --- |
|  |  | $ |
| Proceeds of sale |  | 1,000,000 |
|  |  |  |
| Fair value at the time of sale |  | 1,000,000 |
|  |  |  |
| NBV at the time of sale: | Cost | 1,500,000 |
|  | Depreciation | (750,000) |
|  | NBV | 750,000 |

The remaining useful economic life of the machine at the time of sale is five years.There are five annual lease payments of $277,409 each commencing on 31 December 2015. The implicit rate of interest is 12%.**Required:**(a) Prepare relevant extracts from Lash Ltd’s statement of financial position immediately after the sale on 1 January 2015.(b) Prepare relevant extracts from Lash Ltd’s statement of comprehensive income and statement of financial position for the year ending 31 December 2015.**Solution:**(a) Statement of financial position

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2015** | **2016** | **2017** | **2018** | **2019** |
| **Non-current assets** | **$** | **$** | **$** | **$** | **$** |
| Finance lease asset | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| Acc. depn. | (200,000) | (400,000) | (600,000) | (800,000) | (1,000,000) |
| Carrying value | 800,000 | 600,000 | 400,000 | 200,000 | 0 |
|  |  |  |  |  |  |
| **Liabilities** |  |  |  |  |  |
| Finance lease obligations | 1,000,000 | 842,591 | 666,293 | 468,839 | 247,691 |
| Finance cost @ 12% | 120,000 | 101,111 | 79,955 | 56,261 | 29,723 |
| Repayment in arrears | (277,409) | (277,409) | (277,409) | (277,409) | (277,414) |
|  | 842,591 | 666,293 | 468,839 | 247,691 | 0 |
|  |  |  |  |  |  |
| Comprising: |  |  |  |  |  |
| Non-current liabilities | 666,293 | 468,839 | 247,691 | 247,691 |  |
| Current liabilities | 176,298 | 197,454 | 221,148 |  |  |
| Deferred gain on disposal | 250,000 | 200,000 | 150,000 | 100,000 | 50,000 |
| Recognised in year | (50,000) | (50,000) | (50,000) | (50,000) | (50,000) |
|  | 200,000 | 150,000 | 100,000 | 50,000 | 0 |
|  |  |  |  |  |  |
| Comprising: |  |  |  |  |  |
| Due for release after one year | 150,000 | 100,000 | 50,000 | 0 | 0 |
| Due for release within one year | 50,000 | 50,000 | 50,000 | 50,000 | 0 |

(b) Income statement

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2015** | **2016** | **2017** | **2018** | **2019** |
|  | **$** | **$** | **$** | **$** | **$** |
| Deferred income | (50,000) | (50,000) | (50,000) | (50,000) | (50,000) |
|  |  |  |  |  |  |
| Depreciation charge | 200,000 | 200,000 | 200,000 | 200,000 | 200,000 |
| Finance cost | 120,000 | 101,111 | 79,955 | 56,261 | 29,723 |

 |

**5. Current Issue**

5.1 The IASB and FASB have commenced a project to converge lease accounting since July 2006. After a discussion paper issued in 2009 and an exposure draft issued in 2010, deliberations on the proposal continued in 2011.

5.2 The existing accounting models for leases require lessors and lessees to classify them as either finance leases or operating leases. However, the models have been **criticized** on certain aspects:

(a) It can be argued that operating leases give rise to assets and liabilities that should be recognised in the financial statements of lessees. Consequently, users may adjust the amounts recognised in financial statements in an attempt to recognize those assets and liabilities and reflect the effect of lease contracts in profit or loss. The **information available to users in the notes to the financial statements** is often **insufficient to make reliable adjustments** to the financial statements.

(b) The **existence of two different accounting methods** for finance leases and operating leases **means that similar transactions can be accounted for very differently**. This **affects the comparability of financial statements**. Also **current accounting standards provide opportunities to structure transactions so as to achieve a specific lease classification**. If the lease is classified as an operating lease, the lessee obtains a source of financing that can be difficult for users to understand, as it is not recognised in the financial statements.

(c) Existing accounting methods have been criticised for their **complexity**. In particular, it has proved difficult to define the dividing line between the principles relating to finance and operating leases. As a result, **standards use a mixture of subjective judgments** **and rule based criteria** that can be **difficult to apply**.

(d) The existing accounting model can be said to be **conceptually flawed**. On entering an **operating lease** contract, the **lessee obtains a valuable right to use the leased item**. This **right meets the Framework’s definition of an asset**. Additionally the lessee assumes an **obligation to pay rentals** that **meet the Framework’s definition of a liability**. However, if the lessee classifies the lease as an operating lease, that **right and obligation are not recognised**.

(e) There are significant and growing differences between the accounting methods for leases and other contractual arrangements. This has **led to inconsistent accounting for arrangements** that meet the definition of a lease and similar arrangements that do not. For example **leases are financial instruments but they are scoped out of** HKAS 32, HKAS 39 and HKFRS 9.

|  |  |
| --- | --- |
| 5.3 | What is being proposed? |
|  | (a) The aim of the project is to **develop a single approach** to lease accounting that would ensure all assets and liabilities arising from lease contracts are recognized in the statement of financial position.(b) A lessee has **acquired a right to use** the underlying asset, and it **pays for that right** with the lease payments. A lessee would record:(i) an asset for its right to use the underlying asset (the **right-of-use asset**), and (ii) a liability to pay rentals (liability for lease payments).(c) The **right-of-use asset** would **originally be recorded at the present value of the lease payments**. It would **then** be **amortised over the life of the lease and tested for impairment**. A lessee **could revalue** its right-of-use assets.(d) The **right-of-use asset** would be **presented** **within the property, plant and equipment** category on the statement of financial position **but separately from assets that the lessee owns**.(e) For all **short-term leases** (12 months or less), the **lease assets or lease liabilities** for a class of underlying assets would **not be recognized**. |

**Additional Examination Style Questions**

**Question 7 – Classification of lease**

On 1 January 20X7, Thompson Manufacturing Inc. (TMI), the lessor, entered into a non-cancellable lease agreement for equipment with Silver Rod Company (SRC), the lessee. The following information pertains to the lease:

|  |  |
| --- | --- |
| Annual lease payment due at the beginning of each year, beginning on 1 January 20X7 | $53,069 |
| Option to purchase at the end of lease term | $10,000 |
| Lease term | 5 years |
| Economic useful life of leased equipment | 8 years |
| Lessor’s manufacturing cost | $200,000 |
| Fair value of leased equipment at 1 January 20X7 | $227,500 |
| Estimated unguaranteed residual value of leased equipment at the end of lease term | $30,000 |
| Lessor’s implicit rate | 12.93% |
| Lessee’s incremental borrowing rate | 10% |

**Required:**

**(a) Discuss how the purchase option at the end of the lease term offered by TMI to SRC will affect the classification of this lease by SRC. (3 marks)**

**(b) Prepare an amortisation schedule that would be suitable for TMI for the lease term.**

 **(5 marks)**

**(c) Prepare all the journal entries that TMI should make for each of the years ended 31 December 20X7 and 20X8. (7 marks)**

 **(HKICPA QP Module A Financial Reporting September 2008 Q3)**

**Question 8 – Classification of lease and prior period errors (HKAS 8)**

Quality Manufacturing Limited (“QML”) is a manufacturer of aluminum products. In order to reduce the initial capital investment and to increase the productivity to meet the market demand for its products at the same time, QML has entered into the following leases:

(i) A machine (Machine A) was rented from a supplier for a fixed term of 6 years at a monthly rental of HK$18,000 with a lump sum payment of HK$200,000 at the end of the lease period. The estimated fair values of Machine A at inception of the lease and at the end of the lease are HK$3,500,000 and HK$2,000,000 respectively. The machine’s estimated useful life is 15 years. The lease is non-cancellable and there are no rights to extend the lease term or purchase the machine at the end of the lease term. The machine is required to be returned to the supplier upon expiry of the lease term.

(ii) Another machine (Machine B) was rented from a supplier under a 4-year non-cancellable lease. The monthly rental for Machine B is HK$20,000. The estimated fair values of Machine B at inception of the lease and at the end of the lease are HK$920,000 and HK$20,000 respectively. At the end of the lease term, QML has an option to buy Machine B from the supplier at HK$1,000. The machine’s estimated useful life is 5 years.

(iii) During the year ended 31 December 2012, a machine (Machine C) was rented from a supplier for a fixed term of 5 years at a monthly rental of HK$25,000. The estimated fair values of the Machine C at inception of the lease and at the end of the lease are HK$5,000,000 and HK$3,500,000 respectively. The machine’s estimated useful life is 20 years. The lease is cancellable at a penalty of HK$50,000 with two months’ notice. There are no rights to extend the lease term or purchase the machines at the end of the lease term. The machine is required to be returned to the supplier upon expiry of the lease term.

QML has recognised all the rental payments under the lease as an asset and a liability at the inception of the lease. Machine C is also depreciated using the straight line method over the lease term of 5 years.

**Required:**

**(a) Advise as to whether Machine A and Machine B are under an operating lease or a finance lease. (10 marks)**

**(b) (i) Advise as to whether Machine C is under an operating lease or a finance lease; and**

 **(4 marks)**

**(ii) Advise as to the accounting implication of Machine C in preparing the financial statements of QML for the year ended 31 December 2014. Calculation is not required. (6 marks)**

 **(20 marks – approximately 36 minutes)**

 **(HKICPA QP Module A Financial Reporting June 2016 Q5)**