**ACCOUNTING FOR LEASES**

A lease is a contract specifying the terms under which the owner of property, the lessor, transfers the right to use the property to a lessee. In this topic, we focus on how leases are accounted for from both the lessor’s and the lessee’s perspectives. We will discuss the issues associated with classifying a lease as a debt-financed purchase of property (capital lease) or as a rental (operating lease) and the disclosure issues associated with that classification. In addition, we will illustrate how businesses can have definite obligations to pay significant amounts of money in the future relating to operating lease obligations yet not recognize those obligations as liabilities on the balance sheet.

Historically, a major challenge for the accounting profession has been to establish accounting standards that prevent companies from using the legal form of a lease to avoid recognizing future payment obligations as a liability. “Off-balance-sheet financing” continues to be a perplexing problem for the accounting profession, and leasing is probably the oldest and most widely used means of keeping debt off the balance sheet. This chapter will discuss in detail and analyze the criteria established by the IASB in an attempt to bring more long-term leases onto the balance sheet as well as specific accounting procedures used for leased assets.

**The advantages of leasing**

The lessee (the party using the leased asset) enjoys flexibility and reduced risk through leasing rather than buying. The lessor (the party that owns the leased asset) uses the attractiveness of leasing to increase sales and establish long-term relationships with customers. Other advantages include;

* No down payment

Most debt-financed purchases of property require a portion of the purchase price to be paid immediately by the borrower. This provides added protection to the lender in the event of default and repossession. Lease agreements, in contrast, frequently are structured so that 100% of the value of the property is financed through the lease. This aspect of leasing makes it an attractive alternative to a company that does not have sufficient cash for a down payment or wishes to use available capital for other operating or investing purposes.

* Avoid risks of ownership.

There are many risks accompanying the ownership of property. These risks include casualty loss, obsolescence, changing economic conditions, and physical deterioration. If the market value of a leased asset decreases dramatically, the lessee may terminate the lease, although usually with some penalty. On the other hand, if you own the asset, you are stuck with it when the market value declines.

* Flexibility.

Business conditions and requirements change over time. If assets are leased, a company can more easily replace assets in response to these changes. This flexibility is especially important in businesses where innovation and technological change make the future usefulness of particular equipment or facilities highly uncertain. A prime example of this condition in recent years has been in high-tech industries with rapid change in areas such as computer technology, robotics, and telecommunications. Flexibility is a primary reason for the popularity of automobile leasing. Car buyers like the flexibility of choosing a brand new car every two or three years as their leases run out.

The lessor also may find benefits to leasing its property rather than selling it. Advantages of the lease to the lessor include the following:

* Increased sales.

For the reasons suggested in the preceding paragraphs, customers may be unwilling or unable to purchase property. By offering potential customers the option of leasing its products, a manufacturer or dealer may significantly increase its sales volume.

* Ongoing business relationship with lessee.

When property is sold, the purchaser frequently has no more dealings with the seller of the property. In leasing situations, however, the lessor and lessee maintain contact over a period of time, and long-term business relationships often can be established through leasing.

* Residual value retained.

In many lease arrangements, title to the leased property never passes to the lessee. The lessor benefits from economic conditions that may result in a significant residual value at the end of the lease term. May lease the asset to another lessee or sell the property and realize an immediate gain. For example, new car leasing provides auto dealers with a supply of 2- to 3-year-old used cars, which can then be sold or leased again.

**A simple example will be used to introduce the accounting issues associated with leases. Owner Company owns a piece of equipment with a market value of Ksh.10,000. User Company wishes to acquire the equipment for use in its operations. One option for User Company is to purchase the equipment from Owner by borrowing Ksh.10,000 from a bank at an interest rate of 10%. User can use the Ksh.10,000 to buy the equipment from Owner and can repay the principal and interest on the bank loan in five equal annual installments of Ksh.2,638. Alternatively, User Company can lease the asset from Owner for five years, making five annual “rental” payments of Ksh.2,638. From User’s standpoint, the lease is equivalent to purchasing the asset, the only difference being the legal form of the transaction. User will still use the equipment for five years and will still make payments of Ksh.2,638 per year. From Owner’s standpoint, the only difference in the transaction is that now Owner is not just selling the equipment but is also substituting for the bank in providing financing. With this lease arrangement, the key accounting issue for Owner Company is as follows:**

**On the date the lease is signed, should Owner Company recognize an equipment sale?**

**The correct answer to this question hinges on factors that have been discussed in previous courses in connection with inventory sales and revenue recognition.**

**Has effective ownership of the equipment been passed from Owner to User?**

**Is the transaction complete, meaning does Owner have any significant responsibilities remaining in regard to the equipment?**

**Is Owner reasonably certain that the five annual payments of Ksh.2,638 can be collected from user?**

The key accounting issue for User Company is as follows:

**On the date the lease is signed, should User recognize the leased equipment as an asset and the obligation to make the lease payments as a liability?**

The correct answer to this question also hinges on whether effective ownership, as opposed to legal ownership, of the equipment changes hands when Owner and User sign the lease agreement. Accounting for leases is a classic illustration of the accounting aphorism “substance over form.” The legal form of the lease is that Owner Company maintains ownership of the equipment, but whether the lease transfers economic ownership of the asset from Owner to User depends on the specifics of the lease agreement. Consider the following four independent scenarios:

The lease agreement stipulates that Owner is to maintain legal title to the equipment for the 5-year lease period, but title is to pass to User at the end of the lease.

The lease agreement stipulates that Owner is to maintain legal title to the equipment for the 5-year lease period, but at the end of the lease period user has the option to buy the equipment for Ksh.1.

The useful life of the equipment is just five years. Accordingly, when the lease term is over, the equipment can no longer be used by anyone else. Present value calculations suggest that payment of the five annual Ksh.2,638 lease payments is equivalent to paying Ksh.10,000 for the equipment on the lease-signing date. In each of these four scenarios, the economic substance of the lease is that the lease signing is equivalent to the transfer of effective ownership, and the fact that Owner retains legal title of the equipment during the lease period is a mere technicality. On the other hand, if the lease agreement does not provide for the transfer of the legal title at the end of the lease, if the lease covers only a fraction of the useful life of the equipment, and if the lease payments are not large enough to “pay” for the equipment, then economically the lease is just a rental, not a transfer of ownership.

For accounting purposes, leases are separated into two groups, **capital leases** and **operating leases**. Capital leases are accounted for as if the lease agreement transfers ownership of the asset from the lessor to the lessee. In the preceding example, if the lease is accounted for as a capital lease, Owner Company would recognize the sale of the equipment on the lease-signing date and would recognize earned interest revenue as the five annual lease payments are collected. On the lease-signing date, User Company would recognize the leased asset, as well as the liability for the future lease payments, on its balance sheet. Operating leases are accounted for as rental agreements, with no transfer of effective ownership associated with the lease. In the foregoing example, if the lease is accounted for as an operating lease, Owner Company recognizes no sale on the lease-signing date. Instead, lease rental revenue is recognized each year when the lease payment is collected. User Company recognizes no leased asset and no lease liability but reports only a periodic lease rental expense equal to the annual lease payments.

From this simple introduction, you may receive the misleading impression that accounting for leases is straightforward and noncontroversial. In fact, most companies using assets under lease agreements go to great lengths to ensure that they can account for the bulk of their leases as operating leases because it allows them to keep both the asset and the associated liability off the balance sheet. Keeping the asset off the balance sheet improves financial ratio measures of efficiency, and keeping the liability off the balance sheet improves measures of leverage. For companies that lease a large portion of the assets that they use, the accounting standards associated with leasing are the most critical accounting standards that they apply.

**NATURE OF LEASES**

Leases vary widely in their contractual provisions. Reasons for this variability include cancellation provisions and penalties, bargain renewal and purchase options, lease term, economic life of assets, residual asset values, minimum lease payments, interest rates implicit in the lease agreement, and the degree of risk assumed by the lessee, including payments of certain costs such as maintenance, insurance, and taxes. These and other relevant facts must be considered in determining the appropriate accounting treatment of a lease. The many variables affecting lease capitalization have been given precise definitions that must be understood in order to account for the various types of leases found in practice. Each of these variables is defined and briefly discussed in the following sections.

**Cancellation Provisions**

Some leases are non-cancelable, meaning that these lease contracts are cancelable only on the outcome of some remote contingency or that the cancellation provisions and penalties of these leases are so costly to the lessee that, in all likelihood, cancellation will not occur. All cancelable leases are accounted for as operating leases; some, but not all, non-cancelable leases are accounted for as capital leases.

**Bargain Purchase Option**

Leases often include a provision giving the lessee the right to purchase leased property at some future date. If the specified purchase option price is expected to be considerably less than the fair value at the date the purchase option may be exercised, the option is called a bargain purchase option. By definition, a bargain purchase option is one that is expected to be exercised. Accordingly, a lease agreement including a bargain purchase option is likely to result in the transfer of asset ownership from the lessor to the lessee. Non-cancelable leases with bargain purchase options are accounted for as capital leases.

**Lease Term**

An important variable in lease agreements is the lease term, that is, the time period from the beginning to the end of the lease. The beginning of the lease term occurs when the leased property is transferred to the lessee. The end of the lease term is more flexible because many leases include provisions allowing the lessee to extend the lease period. For accounting purposes, the end of the lease term is defined as the end of the fixed non-cancelable lease period plus all renewal option periods that are likely to be exercised. A bargain renewal option is one with such an attractive lease rate, or other favorable provision, that at the inception of the lease, it is likely that the lease will be renewed beyond the fixed lease period. If a bargain purchase option is included in the lease contract, the lease term includes any renewal periods preceding the date of the bargain purchase option but does not extend beyond the date of the bargain purchase option.

**Residual Value**

The market value of the leased property at the end of the lease term is referred to as its residual value. In some leases, the lease term extends over the entire economic life of the asset or the period in which the asset continues to be productive, and there is little, if any, residual value. In other leases, the lease term is shorter, and a significant residual value does exist. If the lessee can purchase the asset at the end of the lease term at a materially reduced price from its residual value, a bargain purchase option is present, and it can be assumed that the lessee would exercise the option and purchase the asset.

Some lease contracts require the lessee to guarantee a minimum residual value. If the market value at the end of the lease term falls below the guaranteed residual value, the lessee must pay the difference. This provision protects the lessor from loss due to unexpected declines in the market value of the asset. For example, assume that the car you lease is expected to have a Ksh.15, 000 residual value at the end of the lease term and that you guarantee that amount to the car dealership. However, at the end of the lease term, the residual value of the car is only Ksh.10, 000. You are then obligated to pay the dealership the Ksh.5, 000 difference because the dealership is, in effect, guaranteed the full amount of the residual value that was estimated at the beginning of the lease. You may buy the car for the Ksh.15, 000 guaranteed amounts, but the lease terms do not require the purchase. If there is no bargain purchase option or guarantee of the residual value, the lessor reacquires the property at the end of the lease term and may offer to renew the lease, lease the asset to another lessee, or sell the property. The actual amount of the residual value is unknown until the end of the lease term; however, it must be estimated at the inception of the lease. The residual value under these circumstances is referred to as the unguaranteed residual value.

**Minimum Lease Payments**

The rental payments required over the lease term plus any amount to be paid for the residual value either through a bargain purchase option or a guarantee of the residual value are referred to as the minimum lease payments. Lease payments sometimes include charges for items such as insurance, maintenance, and taxes incurred for the leased property. These are referred to as executory costs, and they are not included as part of the minimum lease payments. In addition, building lease payments are often composed of a fixed minimum amount with additional payments made based on sales by the lessee. The additional payments are not considered part of the minimum lease payment. To illustrate the computation of minimum lease payments, assume that D. Leasing Co. owns and leases road equipment for three years at Ksh.3,000 per month. Included in the lease payment is Ksh.500 per month for executory costs to insure and maintain the equipment. At the end of the 3-year period, D. is guaranteed a residual value of Ksh.10,000 by the lessee.

Minimum lease payments

Rental payments (Excluding executory costs) 90,000.00

Guaranteed residual value 10,000.00

TOTAL 100,000.00

How did D. decide that a Ksh.2,500 monthly lease payment would be sufficient? Calculation of the appropriate lease payment involves consideration of the fair value of the leased equipment, the guaranteed residual value, the lease term, and the appropriate interest rate. D. computed the Ksh.2,500 monthly lease payment by using an interest rate of 12% compounded monthly (1% per month) and a fair value of the road equipment of Ksh.82,258. The computation is as follows:

Present value of 36 monthly payments of Ksh.2,500 (Ksh.3,000 less executory costs of Ksh.500) at 1% interest

(12% compounded monthly) paid at the end of each month: (PVIAF, 36 months, 1% per month) 75,269.00

PV of Ksh.10,000 guaranteed residual value at the end of three years at 12% compounded monthly 6,989.00

82,258.00

**NB:**

**The lease classification criteria were designed by the IASB to capture the idea of the transfer of economic ownership. In practice, these criteria are often used by companies in designing leases to make sure that they get the accounting treatment (either capital or operating) that they desire. If a lease involves a transfer of ownership, a bargain purchase option, a lease term greater than or equal to 75% of the economic life of the leased asset, or minimum payments with a present value of at least 90% of the fair value of the leased asset, then the lease is accounted for as a capital lease. Otherwise, the lease is accounted for as an operating lease.**

|  |  |  |
| --- | --- | --- |
| **Capital lease** | **Criteria for classification** | **Operating lease** |
| YES | Is there transfer of title/ ownership? | NO |
| YES | Is there a bargain or purchase option? | NO |
| YES | Lease term>=75% of useful life of asset? | NO |
| YES | Present value of payments >=90% of fair value of assets? | NO |
| Additional *revenue recognition* criteria applicable to lessors:   1. Collectability of the minimum lease payments is reasonably predictable. 2. No important uncertainties surround the amount of un-reimbursable costs yet to be incurred by the lessor.   **Lessee:** Capital lease if any one of general criteria is met.  **Lessor:** Capital lease if any one of general criteria is met and both revenuerecognition criteria are met. | | |

**Criteria for distinguishing between operating and finance/ capital leases**

(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;

(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;

In addition to meeting one of the four general criteria, a lease must meet two additional revenue recognition criteria to be classified by the lessor as a capital lease.

The first of the two revenue recognition criteria relates to collectability. Collection of the minimum lease payments must be reasonably predictable.

The second additional criterion requires substantial completion of performance by the lessor. This means that any un-reimbursable costs yet to be incurred by the lessor under the terms of the lease are known or can be reasonably estimated at the lease inception date. If the leased asset is constructed by the lessor, this criterion is applied at the later of the lease inception date or the date construction is completed.

**Accounting for leases- Lessee**

**Accounting for operating leases- Lessee**

Operating leases are considered to be simple rental agreements with debits being made to an expense account as the payments are made. For example, assume the lease terms for manufacturing equipment are Ksh.40, 000 a year on a year-to-year basis. The entry to record the lease payment for a year would be as follows:

Rent Expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,000

Lease payments frequently are made in advance. If the lease period does not coincide with the lessee’s fiscal year or if the lessee prepares interim reports, a prepaid rent account would be required to record the unexpired portion of the lease payment at the end of the accounting period involved. The prepaid rent account would be adjusted at the end of each period.

Prepaid lease Rentals…….. . . .. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,000

**Operating Leases with Varying Lease Payments**

Some operating leases specify lease terms that provide for varying lease payments over the lease term. Most commonly, these types of agreements call for lower initial payments and scheduled increases later in the life of the lease. They may even provide an inducement to prospective lessees in the form of a “rent holiday” (free rent). In some cases, however, the lease may provide for higher initial payments. In cases with varying lease payments, periodic expense should be recognized on a straight-line basis. When recording lease payments under these agreements, differences between the actual payments and the debit to expense would be reported as Rent Payable or Prepaid Rent, depending on whether the payments were accelerating or declining. For example, assume the terms of the lease for an aircraft by International Airlines provide for payments of Ksh.150, 000 a year for the first two years of the lease and Ksh.250, 000 for each of the next three years. The total lease payments for the five years would be Ksh.1, 050,000, or Ksh.210, 000 a year on a straight-line basis. The required entries in the first two years would be as follows:

Rent Expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 210,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……… . . . .…. 150,000

Rent Payable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………….. . . . 60,000

The entries for each of the last three years are as follows:

Rent Expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 210,000

Rent Payable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .. . . . . . 40,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……………. . 250,000

The portion of Rent Payable due in the subsequent year would be classified as a current liability.

NB: A large amount of detail concerning operating leases is disclosed in the notes to the financial statements. This disclosure includes summary information about lease provisions and a schedule of future minimum lease payments associated with operating leases.

**Accounting for Capital Leases—Lessee**

Capital leases are considered to be more like a purchase of property than a rental.Consequently, accounting for capital leases by lessees requires entries similar to thoserequired for the purchase of an asset with long-term credit terms. The amounts to berecorded as an asset and as a liability are the present values of the future minimumlease payments as previously defined. The discount rates used by lessees to recordcapital leases are the same as those used to apply the classification criteria previouslydiscussed, that is, the lower of the implicit interest rate (if known) and the incrementalborrowing rate. The minimum lease payments consist of the total rental payments,bargain purchase options, and lessee-guaranteed residual values.

**Example: Capital/ Finance leases**

Assume that Marshall Corporation leases equipment from Universal Leasing Company with the following terms:

* Lease period: 5 years, beginning January 1, 2011.
* Non-cancelable.
* Rental amount: Ksh.65, 000 per year payable annually in advance; includes Ksh.5, 000 executory costs.
* Estimated economic life of equipment: 5 years.
* Expected residual value of equipment at end of lease period: None.

Because the lease payments are payable in advance, one way to compute the present value of the lease is to add the amount of the first payment (made on the lease-signing date) to the present value of the annuity of four remaining payments. Assuming that Marshall Corporation’s incremental borrowing rate and the implicit interest rate on the lease are both 10%, the present value for the lease would be Ksh.250, 192 computed as follows using a business calculator:

The journal entries to record the lease at the beginning of the lease term would be 2011

Jan. 1

Leased Equipment . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 250,192

Obligations under Capital Leases . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………………….. . . . . . 250,192

*To record the lease*.

Lease Expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……... . . . . .. 5,000

Obligations under Capital Leases . . . . . . . . . . . . . . . . . . . . . . ……………………... . . . . . . . . . ..60,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……... . . . . . ……………. . . . 65,000

*To record the first lease payment (including executory costs of Ksh.5, 000).*

The term *lease expense* is used to record the executory costs related to the leased equipment, such as insurance and taxes.

FYI: when a lease is capitalized, the asset is included on the balance sheet and written off over time. The wordAmortization, instead of depreciation, is typically used when describing the systematic expensing of the cost of leased asset. The entry for amortization will typically be;

2011

Dec. 31 Amortization Expense on Leased Equipment . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 50,038\*

Accumulated Amortization on Leased Equipment . . . . . . . . . . ……………………. . . . . . . . . . . . . . . . 50,038

\*Computation: Ksh.250, 192/5 = Ksh.50, 038.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| **Date** | **Description** | **Amount** | **Interest expense\*** | **Principal** | **Lease obligation** |
| 1/1/11 | Initial Balance | - | - | - | 250,192.00 |
| 1/1/11 | Payment | 60,000 |  | 60,000.00 | 190,192.00 |
| 31/12/11 | Payment | 60,000 | 19,019.00 | 40,981.00 | 149,211.00 |
| 31/12/12 | Payment | 60,000 | 14,921.00 | 45,079.00 | 104,132.00 |
| 31/12/13 | Payment | 60,000 | 10,413.00 | 49,587.00 | 54,545.00 |
| 31/12/14 | Payment | 60,000 | 5,455.00 | 54,545.00 | 0 |

**\***Preceding lease obligation \* 10%.

Similar entries would be made for each of the remaining four years. Although the credit could be made directly to the asset account, the use of a contra asset account provides the necessary disclosure information about the original lease value and accumulated amortization to date. In addition to the entry recording amortization, another entry is required at December 31, 2011, to record the second lease payment, including a prepayment of 2012’s executory costs. As indicated in Exhibit 15-3, the interest expense for 2011 would be computed by multiplying the incremental borrowing rate of 10% by the initial present value of the obligation less the immediate Ksh.60,000 first payment, or

(Ksh.250, 192- Ksh.60, 000) X 0.10= Ksh.19, 019.

2011

Dec. 31

Prepaid Executory Costs . . . . . . . . . . . . . . . . . . . . . …. . . . . . . . . . . . . . . . . . . . . . . . . . . . 5,000

Obligations under Capital Leases . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .. . . . 40,981

Interest Expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .. . . . 19,019

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . …. . . . 65,000

**Accounting for Leases with a Bargain Purchase Option**

Frequently, the lessee is given the option of purchasing the property at some future date at a bargain price. As discussed previously, the present value of the bargain purchase option is part of the minimum lease payments and should be included in the capitalized value of the lease. Assume in the preceding example that there is a bargain purchase option of Ksh.75, 000 exercisable after five years, and the economic life of the equipment is expected to be 10 years. The other lease terms remain the same. The present value of the minimum lease payments would be increased by the present value of the bargain purchase amount of Ksh.75, 000, or Ksh.46, 569, computed as follows:

Toggle back so that the payments are assumed to occur at the end (END) of the period.

*FV* = Ksh.75, 000; *N* = 5; *I* = 10%, *PV* = Ksh.46, 569

The total present value of the future minimum lease payments is Ksh.296, 761 (Ksh.250, 192 + Ksh.46, 569). This amount will be used to record the initial asset and liability. The asset balance of Ksh.296, 761 will be amortized over the asset life of 10 years because of the existence of the bargain purchase option; this makes the transaction, in reality, a sale.

At the date of exercising the option, the net balance in the leased equipment asset account and its related accumulated amortization account would be transferred to the regular equipment account. The entries at the exercise of the option would be as follows:

2015

Dec. 31 Obligations under Capital Leases . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 68,182

Interest Expense . . . . . . . . . . . . . . . . . . . . . . ………….. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 6,818

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………….. . . . . . . . . . . . . . . . . . . . …………. . . . . . . . . . . 75,000

*To record exercise of bargain purchase option*.

Equipment . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……….. . . . . . . . . . . . . . . . . . . . . 148,381

Accumulated Amortization on Leased Equipment . . . . . . . . . . ………….. . . . . . . . . . . . . . . . . 148,380\*

Leased Equipment . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………….. . . . . . . …………. . . . . . . . . 296,761

*To transfer remaining balance in leased asset account to equipment account*.

\*Accumulated amortization: Ksh.296, 761/10 years= Ksh.29, 676 per year; 5 years\* Ksh.29, 676 per year= Ksh.148, 380

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| **Date** | **Description** | **Amount** | **Interest expense\*** | **Principal** | **Lease obligation** |
| 1/1/11 | Initial Balance | - | - | - | 296,761.00 |
| 1/1/11 | Payment | 60,000 |  | 60,000.00 | 236,761.00 |
| 31/12/11 | Payment | 60,000 | 19,019.00 | 40,981.00 | 200,437.00 |
| 31/12/12 | Payment | 60,000 | 14,921.00 | 45,079.00 | 160,481.00 |
| 31/12/13 | Payment | 60,000 | 10,413.00 | 49,587.00 | 116,529.00 |
| 31/12/14 | Payment | 60,000 | 5,455.00 | 54,545.00 | 68,182 |
| 31/12/15 | Payment | 75,000 | 6,818.00 | 68,182.00 | 0 |

Accounting for Leases with a Lessee-Guaranteed Residual Value

If the lease agreement requires the lessee to guarantee a residual value, the lessee treats the guarantee similar to a bargain purchase option and includes the present value of the guarantee as part of the capitalized value of the lease. At the expiration of the lease term, the amount of the guarantee will be reported as a liability under the lease. In addition, the remaining book value of the leased asset will be equal to the guaranteed residual value. If the fair value of the leased asset is less than the guaranteed residual value, a loss is reported for the difference, and the lessee must make up the difference with a cash payment.

Accounting for leases- Lessor

The lessor in a lease transaction gives up the physical possession of the property to the lessee. If the transfer of the property is considered temporary in nature, the lessor will continue to carry the leased asset as an owned asset on the balance sheet; the revenue from the lease will be reported as it is earned; and depreciation of the leased asset will be matched against the revenue. This type of lease is described as an *operating lease*, and cash receipts from the lessee are treated similar to the operating lease procedures described for the lessee. However, if a lease has terms that make the transaction similar in substance to a sale or a permanent transfer of the asset to the lessee, the lessor should no longer report the asset as though it were owned but should reflect the transfer to the lessee. As indicated earlier, if a lease meets one of the four general lease classification criteria that apply to both lessees and lessor’s plus both of the revenue recognition criteria that apply to the lessor only (i.e., collectability and substantial completion), it is classified by the lessor as a *capital lease* and recorded as either a *direct financing lease* or a *sales-type lease.*

**Direct financing leases** involve a lessor who is primarily engaged in financing activities, such as a bank or finance company. The lessor views the lease as an investment. The revenue generated by this type of lease is interest revenue. **Sales-type leases**, on the other hand, involve manufacturers or dealers who use leases as a means of facilitating the marketing of their products. Thus, there are two different types of revenue generated by this type of lease (sales type):

(1) An immediate profit or loss, which is the difference between the cost of the property being leased and its sales price, or fair value, at the inception of the lease and

(2) Interest revenue earned over time as the lessee makes the lease payments that pay off the lease obligation plus interest.

For an operating, direct financing, or sales-type lease, a lessor may incur certain costs, referred to as initial direct costs, in connection with obtaining the lease. These costs include the costs to negotiate the lease, perform the credit check on the lessee, and prepare the lease documents. Initial direct costs are accounted for differently, depending on which of the three types of leases is involved.

The Exhibit below summarizes the accounting treatment for initial direct costs. These costs will be discussed further as each type of lease is presented.

|  |  |
| --- | --- |
| **Type of lease** | **Accounting treatment of initial direct costs** |
| Operating | Recorded as an asset and amortized over lease term. |
| Direct financing | Recorded as an asset and amortized over lease term, reducing interest revenue. |
| Sales-type | Immediately recognized as a reduction in manufacturer’s or dealer’s profit. |

**Accounting for Operating Leases—Lessor**

Accounting for operating leases for the lessor is very similar to that described for the lessee. The lessor recognizes revenue as the payments are received. If there are significant variations in the payment terms, entries will be necessary to reflect a straight-line pattern of revenue recognition. Initial direct costs incurred in connection with an operating lease are deferred and amortized on a straight-line basis over the term of the lease, thus matching them against rent revenue.

To illustrate accounting for an operating lease on the lessor’s books, assume that the equipment leased for five years by Universal Leasing Company to Marshall Corporation (Earlier example on lessee) on January 1, 2011, for Ksh.65,000 a year, including executor costs of Ksh.5,000 per year, had a cost of Ksh.400,000 to the lessor, Universal Leasing. Initial direct costs of Ksh.15,000 were incurred to obtain and finalize the lease. The equipment has an estimated life of 10 years, with no residual value. Assuming no purchase or renewal options or guarantees by the lessee, the lease does not meet any of the four general classification criteria and would be treated as an operating lease. The entries to record the payment of the initial direct costs and the receipt of the lease payments by Universal Leasing would be as follows:

2011

Jan. 1 Deferred Initial Direct Costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 15,000

Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………………… . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 15,000

Cash . . . . . . . . . . . …… . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 65,000

Rent Revenue . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . …………………. . . . . . . . . . . . 60,000

Executory Costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……………………. . . . . . . . . . . . . . 5,000

The Ksh.5,000 payment received from the lessee to reimburse the executory costs may be reflected as a credit (reduction) to the executory costs account, as shown here, or as a credit to a separate revenue account against which the executory costs can be matched.

Assuming the lessor depreciates the equipment on a straight-line basis over its expected life of 10 years and amortizes the initial direct costs on a straight-line basis over the 5-year lease term, the depreciation and amortization entries at the end of the first year would be as follows:

2011

Dec. 31 Amortization of Initial Direct Costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 3,000

Deferred Initial Direct Costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ………………... . . . . . . . 3,000

31 Depreciation Expense on Leased Equipment . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,000

Accumulated Depreciation on Leased Equipment . . . . . . . . . . . . . . …………….. . . . . . . . . . . . 40,000

If the rental period and the lessor’s fiscal year do not coincide or if the lessor prepares interim reports, an adjustment would be required to record the unearned rent revenue at the end of the accounting period. Amortization of the initial direct costs would be adjusted to reflect a partial year.

**Accounting for Direct Financing Leases**

Accounting for direct financing leases for lessors is very similar to that used for capital leases by lessees but with the entries reversed to provide for interest revenue rather than interest expense and reduction of a lease payment receivable rather than a lease liability. The lease payment receivable is reported at its present value; this is the standard practice followed with all long-term receivables, as explained in Chapter 7. The lease payment receivable is sometimes recorded by the lessor at the gross amount of the lease payments with an offsetting valuation account for the unearned interest, or aggregate amount of interest that will be earned by the lessor over the course of the lease. Unearned interest revenue is computed as the difference between the total expected lease payments and the fair value, or cost, of the leased asset. This approach is illustrated for the first year in the following example. Although the remainder of the journal entries in the chapter report the lease payment receivable at its net present value, note that in each case the receivable could be shown at its gross amount less an adjustment for unearned interest revenue.

**Illustrative Entries for Direct Financing Leases**

Referring to the lessee example on earlier example, assume that the cost of the equipment to the Universal Leasing Company was the same as its fair value, Ksh.250,192, and that the purchase by the lessor had been entered into Equipment Purchased for Lease. The entry to record the initial lease would be this:

2011

Jan. 1 Lease Payments Receivable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 250,192

Equipment Purchased for Lease . . . . . . . . . . . . . . . . . . …………………... . . . . . . . . . . . . . . . . . . . . . 250,192

or, if the lease payment receivable is recorded at its gross amount:

Jan. 1 Lease Payments Receivable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 300,000

Equipment Purchased for Lease . . . . . . . . . . . . . . . . . . . . . . . . . . ………………………. . . . . . . . . . . . . . 250,192

Unearned Interest Revenue . . . . . . . . . . . . . . . . . . . . . . . . . . . . …. . ………………………. . . . . . . . . . . . . 49,808

The first payment would be recorded as follows:

Jan. 1 Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 65,000

Lease Payments Receivable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . …………………. . . . . . . 60,000

Executory Costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……………………. . . . . . . . . . . . . 5,000

The lessor is paying the executory costs but charging them to the lessee. The lessor can record the receipt of the executory costs by debiting Cash and crediting the Executory Costs Expense account. As the lessor pays the costs, the expense account is debited. The lessor is serving as a conduit for these costs to the lessee and will have an expense only if the lessee fails to make the payments. Interest revenue will be recognized over the lease term as shown in Exhibit 15-8. At the end of the first year, the following entries would be made to record the receipt of the second lease payment, to recognize the interest revenue for 2011, and to recognize the advance payment for next year’s executory costs as a deferred credit.

2011

Dec. 31 Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 65,000

Lease Payments Receivable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40,981

Interest Revenue . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ... . . . . . . . . 19,019

Deferred Executory Costs (a liability) . . . . . . . . . . . . . . . . . . . . . . . . . . . . ……. . . . . . . . 5,000

or, if the lease payment receivable is recorded at its gross amount:

Dec. 31 Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 65,000

Lease Payments Receivable . . . . . . . . . . . . . . . . . . . . . . …………………... . . . . . . . . . . . . . . . . . . . . . 60,000

Deferred Executory Costs (a liability) . . . . . . . . . . . . . . . . . . ………………………. . . . . . . . . . . . . . . . . . 5,000

31 Unearned Interest Revenue . . . . . . . . . . . . . . . . . . . . . . . . . ………. . . . . . . . . . . . . . . . . . . . . 19,019

Interest Revenue . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . …………………….. . . . . . . . . . . . . . . . 19,019

Notice that unlike the operating lease example, no annual depreciation expense is recorded by the lessor in association with an asset leased under a capital lease agreement. This is because the asset has been “sold” to the lessee and removed from the lessor’s books.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| **Date** | **Description** | **Amount** | **Interest expense\*** | **Principal** | **Lease obligation** |
| 1/1/11 | Initial Balance | - | - | - | 250,192.00 |
| 1/1/11 | Payment | 60,000 |  | 60,000.00 | 190,192.00 |
| 31/12/11 | Payment | 60,000 | 19,019.00 | 40,981.00 | 149,211.00 |
| 31/12/12 | Payment | 60,000 | 14,921.00 | 45,079.00 | 104,132.00 |
| 31/12/13 | Payment | 60,000 | 10,413.00 | 49,587.00 | 54,545.00 |
| 31/12/14 | Payment | 60,000 | 5,455.00 | 54,545.00 | 0 |

Based on the journal entries, the asset portion of the balance sheet of the lessor at December 31, 2011, will report the lease receivable as follows:

If a direct financing lease contains a bargain purchase option, the present value of the option is added to the receivable. The periodic entries and computations are made as though the bargain purchase amount was an additional rental payment.

Accounting for Sales-Type Leases—Lessor

Accounting for sales-type leases adds one more dimension to the lessor’s revenue, an immediate profit or loss arising from the difference between the sales price of the leased property and the lessor’s cost to manufacture or purchase the asset. If there is no difference between the sales price and the lessor’s cost, the lease is not a sales-type lease. The lessor also will recognize interest revenue over the lease term for the difference between the sales price and the gross amount of the minimum lease payments.

The three values that must be identified to determine these income elements, therefore, can be summarized as follows:

1. The minimum lease payments as defined previously for the lessee, that is, rental payments over the lease term net of any executory costs plus the amount to be paid under a bargain purchase option or guarantee of the residual value.

2. The fair value of the asset.

3. The cost or carrying value of the asset to the lessor increased by any initial direct costs to lease the asset.

The manufacturer’s or dealer’s profit is the difference between the fair value of the asset and the cost or carrying value of the asset to the lessor. If cost exceeds the fair value, a loss will be reported. The difference between the gross rentals and the fair value of the asset is interest revenue and arises because of the time delay in paying for the asset as described by the lease terms. The relationship between these three values can be demonstrated as follows:

(1) Minimum lease payments

Financial Revenue

(Interest)

(2) Fair value of leased asset

Manufacturer’s or

Dealer’s Profit (Loss)

(3) Cost or carrying value of leased asset to lessor