

SPECIFIC ITEMS

SECTION 3065

leases

Basis for Conclusions

Leases, Section 3065 (December 2021)

Leases, Section 3065 (November 2020)

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PURPOSE AND SCOPE

- .01 This Section establishes standards for methods of accounting for lease transactions and circumstances in which these methods are appropriate.
- .02 This Section does not cover leasing agreements pertaining to the rights to explore for or to exploit natural resources, nor does it apply to licensing agreements for items such as motion pictures, videotapes, plays, manuscripts, patents and copyrights.

DEFINITIONS

- .03 The following terms are used in this Section with the meanings specified:
 - (a) **Capital lease** is a lease that, from the point of view of the lessee, transfers substantially all the benefits and risks incident to ownership of property to the lessee.
 - (b) **Sales-type lease** is a lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of the leased property is greater or less than its carrying amount, thus giving rise to a profit or loss to the lessor (usually a manufacturer or dealer).
 - (c) **Direct financing lease** is a lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of leased property is the same as its carrying amount to the lessor (usually not a manufacturer or dealer). A lease is not precluded from being classified as a direct financing lease after it is renewed or extended even though the carrying amount of the property at the end of the original lease term is different from its fair value at that date.
 - (d) **Operating lease** is a lease in which the lessor does not transfer substantially all the benefits and risks incident to ownership of property.
 - (e) **Bargain purchase option** is a provision allowing the lessee, at its option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property, at the date the option becomes exercisable, that exercise of the option appears, at the inception of the lease, to be reasonably assured.
 - (f) **Bargain renewal option** is a provision allowing the lessee, at its option, to renew the lease for a rental that is sufficiently lower than the expected fair rental of the property, at the date the option becomes exercisable, that exercise of the option appears, at the inception of the lease, to be reasonably assured. "Fair rental" means the going rate for rental of equivalent property under similar terms and conditions.
 - (g) **Contingent rental** is a rental based on a factor other than the passage of time (for example, percentage of sales, amount of usage, prime interest rate, price indices).
 - (h) **Economic life of the leased property** is the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease and without limitation by the lease term.
 - (i) **Executory costs** are costs related to the operation of the leased property (for example, insurance, maintenance cost and property taxes).
 - (j) **Fair value** is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.
 - (i) When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will usually be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value would be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price.
 - (ii) When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will usually be its cost to the lessor, reflecting any volume or trade discounts that may be applicable. However, when there has been a lapse of time between the date of acquisition of the property by the lessor and the inception of

the lease, the determination of fair value would be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying value.

- (k) **Inception of the lease** is the earlier of the date of the lease agreement and the date of a commitment that is signed by the parties to the lease transaction and includes the principal terms of the lease (this is the effective date used for classification of the lease).
- (l) **Initial direct costs** are those costs incurred by the lessor that are directly associated with negotiating and executing a specific leasing transaction. Such costs include commissions, legal fees and costs of preparing and processing documents for new leases. Such costs do not include supervisory and administrative costs, promotion and lease design costs intended for recurring use, costs incurred in collection activities and provisions for uncollectable rentals.
- (m) **Interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of:
 - (i) the minimum lease payments, from the standpoint of the lessor, excluding that portion of the payments representing executory costs to be paid by the lessor and any profit on such costs; and
 - (ii) the unguaranteed residual value accruing to the benefit of the lessor;to be equal to the fair value of the leased property to the lessor at the inception of the lease.
- (n) **Lease** is the conveyance, by a lessor to a lessee, of the right to use a tangible asset, usually for a specified period of time in return for rent.
- (o) **Lease inducements** are incentives for a lessee to sign a lease (for example, an up-front cash payment to the lessee, an initial rent-free period or reduced rent payments in early periods, the reimbursement of costs of the lessee such as moving costs or leasehold improvements, or the assumption by the lessor of the lessee's pre-existing lease).
- (p) **Lease term** is the fixed non-cancellable period of the lease plus:
 - (i) all periods covered by bargain renewal options;
 - (ii) all periods for which failure to renew would impose on the lessee a penalty sufficiently large that renewal appears, at the inception of the lease, reasonably assured;
 - (iii) all periods covered by ordinary renewal options during which the lessee has undertaken to guarantee the lessor's debt related to the leased property;
 - (iv) all periods covered by ordinary renewal options preceding the date on which a bargain purchase option is exercisable; and
 - (v) all periods representing renewals or extensions of the lease at the lessor's option;provided that the lease term does not extend beyond the date a bargain purchase option becomes exercisable.
The lease term is considered to be non-cancellable if cancellation is possible only:
 - (i) upon the occurrence of some unlikely contingency;
 - (ii) with permission of the lessor;
 - (iii) upon the lessee entering into a new lease for the same or equivalent property with the same lessor; or
 - (iv) upon payment by the lessee of a penalty sufficiently large that continuation of the lease appears, at the inception of the lease, reasonably assured.
- (q) **Lessee's rate for incremental borrowing** is the interest rate that, at the inception of the lease, the lessee would have incurred to borrow, over a similar term and with similar security for the borrowing, the funds necessary to purchase the leased asset.
- (r) **Minimum lease payments**
 - (i) From the point of view of the lessee, minimum lease payments comprise:
 - the minimum rental payments called for by the lease over the lease term;
 - any partial or full guarantee, by the lessee or a third party related to the lessee, of the residual value of the leased property at the end of the lease term (when the lessee agrees to make up a deficiency in the lessor's realization of the residual value below a stated amount, the guarantee to be included in the minimum lease payments is the stated amount rather than an estimate of the deficiency to be made up); and
 - any penalty required to be paid by the lessee for failure to renew or extend the lease at the end of the lease term;provided that if the lease contains a bargain purchase option, only the total of the minimum rental payments over the lease term and the payment called for by the bargain purchase option is included in minimum lease payments. Lease payments that depend on factors measurable at the inception of the lease, such as the

consumer price index or the prime interest rate, are not, in substance, contingent rentals in their entirety, and are included in the minimum lease payments, based on the index or rate existing at the inception of the lease.

(ii) From the point of view of the lessor, minimum lease payments comprise:

- minimum lease payments for the lessee as described above; and
- any residual value or rental payments beyond the lease term guaranteed by a third party unrelated to either the lessee or lessor, provided that the guarantor is financially capable of discharging the obligations under the guarantee.

(s) **Residual value of the leased property** is the estimated fair value of the leased property at the end of the lease term.

(t) **Sale-leaseback transaction** is the sale of property with the purchaser leasing the property back to the seller.

(u) **Unguaranteed residual value** is that portion of the residual value of leased property that is not guaranteed or is guaranteed solely by a party related to the lessor.

CLASSIFICATION

.04 This Section classifies leases as follows:

- (a) from the point of view of the lessee — capital and operating leases; and
- (b) from the point of view of the lessor — sales-type, direct financing and operating leases.

.05 This Section adopts the view that property has benefits and risks associated with its ownership. Benefits may be represented by the expectation of profitable operation over the property's economic life and of gain from appreciation in value or realization of a residual value. Risks include possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. This Section adopts the view that a lease that transfers substantially all of the benefits and risks of ownership to the lessee is in substance an acquisition of an asset and an incurrence of an obligation by the lessee and a sale or financing by the lessor.

.06 From the point of view of a lessee, a lease normally transfers substantially all of the benefits and risks of ownership to the lessee when, at the inception of the lease, one or more of the following conditions are present:

- (a) There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. Reasonable assurance that the lessee will obtain ownership of the leased property is present when the terms of the lease result in ownership being transferred to the lessee by the end of the lease term or when the lease provides for a bargain purchase option.
- (b) The lease term is of such a duration that the lessee will receive substantially all of the economic benefits expected to be derived from the use of the leased property over its life span. Although the lease term may not be equal to the economic life of the leased property in terms of years, the lessee is normally expected to receive substantially all of the economic benefits to be derived from the leased property when the lease term is equal to a major portion (usually 75 percent or more) of the economic life of the leased property. This is due to the fact that new equipment, reflecting later technology and in prime condition, may be assumed to be more efficient than old equipment that has been subject to obsolescence and wear.
- (c) The lessor is assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement. This condition exists if the present value, at the beginning of the lease term, of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (usually 90 percent or more) of the fair value of the leased property, at the inception of the lease. In determining the present value, the discount rate used by the lessee is the lower of the lessee's rate for incremental borrowing and the interest rate implicit in the lease, if known.

In view of the fact that land normally has an indefinite useful life, it is not possible for the lessee to receive substantially all the benefits and risks associated with its ownership, unless there is reasonable assurance that ownership will pass to the lessee by the end of the lease term.

.07 From the point of view of a lessor, a lease normally transfers substantially all of the benefits and risks of ownership to the lessee when, at the inception of the lease, all the following conditions are present:

- (a) any one of the conditions in paragraph 3065.06;
- (b) the credit risk associated with the lease is normal when compared to the risk of collection of similar receivables; and
- (c) the amounts of any unreimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated. If such costs are not reasonably estimable, the lessor may retain substantial risks in connection with the leased property. For example, this may occur when the lessor has a commitment to guarantee the performance of, or to effectively protect the lessee from obsolescence of, the leased property.

- When assessing whether the condition set out in paragraph 3065.06(c) exists, the discount rate used by the lessor is the interest rate implicit in the lease.
- .08 Other conditions have been advanced as evidence that substantially all the benefits and risks of ownership have been transferred to the lessee. The existence of any of the following conditions by themselves is not sufficient evidence that substantially all the benefits and risks of ownership have been transferred to the lessee:
- (a) Lessee pays cost incident to ownership. This condition is considered inappropriate because in virtually all leasing agreements the lessee will either directly or indirectly pay such costs.
 - (b) Lessee has the option to purchase the asset for the lessor's unrecovered investment. This condition is considered inappropriate because there is no assurance that the lessee will exercise the option.
 - (c) Leased property is special purpose to the lessee. This condition is considered insufficient because the concept of "special purpose" is relative and difficult to define. In addition, the fact that the leased property is special purpose does not, in itself, evidence a transfer of substantially all of the benefits and risks of asset ownership. Although it is expected that most lessors lease special purpose property only under terms that transfer substantially all of those benefits and risks to the lessee, nothing in the nature of special purpose property necessarily entails such terms.
- .09 *A lease that transfers substantially all of the benefits and risks of ownership related to the leased property from the lessor to the lessee shall be accounted for as a capital lease by the lessee and as a sales-type or direct financing lease by the lessor.*
- .10 *A lease in which the benefits and risks of ownership related to the leased property are substantially retained by the lessor shall be accounted for as an operating lease by the lessee and lessor.*
- .11 Except as specified in paragraphs 3065.11A-11C, a renewal, an extension or a change in the provisions of an existing lease shall be considered as a new lease and classified in accordance with paragraphs 3065.09.-10 (for a renewal or extension of an existing sales-type lease, see paragraph 3065.45).
- .11A As a practical expedient, a lessee or a lessor that receives or grants a rent concession in the form of a deferral or waiver of lease payments may choose to not account for the rent concession as a new lease, as required by paragraph 3065.11, when all of the following conditions are met:
- (a) the rent concession occurred as a direct consequence of the COVID-19 pandemic;
 - (b) the total payments resulting from the rent concession are the same or less than the total payments required by the original lease contract. A rent concession that increases the total payments required for the lease contract would not be considered a direct consequence of the COVID-19 pandemic, except to the extent the increase reflects the time value of money; and
 - (c) any reduction in lease payments affects only payments originally due on or before December 31, 2022 (for example, a rent concession in the form of a deferral of lease payments will meet this condition if it results in reduced lease payments on or before December 31, 2022, but the lease payments are paid after December 31, 2022).
- An enterprise is permitted to apply this practical expedient for each rent concession on a lease-by-lease basis. An enterprise that chooses this practical expedient accounts for the rent concession in accordance with paragraphs 3065.11B-.11C.
- .11B For a rent concession that results in a deferral of lease payments with no change to the total payments required by the original lease contract, an enterprise accounts for the rent concession as if no changes to the lease contract were made. During the deferral period, a lessee and a lessor continue to account for the lease consistent with the terms of the original lease contract, which means:
- (a) for an operating lease, a lessee will continue to recognize lease expense and a lessor will continue to recognize lease revenue consistent with the terms of the original lease;
 - (b) for a capital lease, a lessee will continue to recognize interest expense and continue to amortize the leased asset consistent with the terms of the original lease; and
 - (c) for a sales-type or direct financing lease, a lessor will continue to recognize interest income consistent with the terms of the original lease.
- To account for the rent concession during the deferral period, a lessee recognizes a lease payable and a lessor recognizes a lease receivable for the amount of lease payments deferred.
- .11C For a rent concession that results in the total payments required to be less than the total payments required by the original lease contract, an enterprise recognizes the reduction in total payments in net income in the period to which the lease payments relate. A lessee and a lessor continue to account for the lease consistent with the terms of the original lease contract, which means:
- (a) for an operating lease, a lessee will continue to recognize lease expense and a lessor will continue to recognize lease revenue consistent with the terms of the original lease;
 - (b) for a capital lease, a lessee will continue to recognize interest expense and amortize the leased asset consistent with the terms of the original lease;
 - (c) for a sales-type or direct financing lease, a lessor will continue to recognize interest income consistent with the terms of the original lease.

To account for the rent concession, a lessee and a lessor will recognize the reduction in total lease payments in net income in the period to which the lease payments relate.

- .12 When the classification of a lease, arising from a renewal, an extension or a change in the provisions of an existing lease, results in a capital lease being replaced by an operating lease, the asset and related obligation are removed from the accounts of the lessee. The net adjustment is included in income of the period. When the classification of the new lease is the same as the original lease, the asset and obligation related to the original lease are adjusted to conform to the recalculated balances.
- .13 When the classification of a lease, arising from a renewal, an extension or change in the provisions of an existing lease, results in a sales-type or direct financing lease being replaced by an operating lease, the remaining net investment is removed from the accounts of the lessor and the leased asset recorded as an asset at the lower of its original cost, present fair value or present carrying amount. The net adjustment is included in income of the period.

ACCOUNTING TREATMENT BY A LESSEE

Method of accounting for a capital lease

- .14 To report the total resources at the lessee's disposal and all aspects of the lessee's long-term obligations, a capital lease shall be accounted for by the lessee as an acquisition of an asset and an assumption of an obligation.
- .15 *The lessee shall account for a capital lease as an asset and an obligation.*
- .16 The asset value and the amount of the obligation, recorded at the beginning of the lease term, are the present value of the minimum lease payments, excluding the portion thereof relating to executory costs. The amount relating to executory costs included in the minimum lease payments are estimated if not known to the lessee. The interest rate implicit in the lease is affected by the residual value of the leased property in which the lessee usually has no interest. As a result, to use the interest rate implicit in the lease as the discount rate when it is higher than the lessee's rate for incremental borrowing would produce an amount that is less representative of the value of the asset to the lessee than would be obtained by using the lessee's rate for incremental borrowing as the discount rate. Therefore, the discount rate used by the lessee in determining the present value of minimum lease payments shall be the lower of the lessee's rate for incremental borrowing and the interest rate implicit in the lease, if practicable to determine. Notwithstanding the foregoing, the maximum value recorded for the asset and obligation may not exceed the leased asset's fair value.
- .17 The capitalized value of a depreciable asset under a capital lease shall be amortized over the period of expected use, on a basis that is consistent with the lessee's depreciation policy for other similar fixed assets (see PROPERTY, PLANT AND EQUIPMENT, Section 3061). If the lease contains terms that allow ownership to pass to the lessee or a bargain purchase option, the period of amortization shall be the economic life of the asset. Otherwise, the property shall be amortized over the lease term.
- .18 An obligation under a capital lease is similar to a loan. Lease payments shall be allocated to a reduction of the obligation, interest expense and any related executory costs. The interest expense is calculated using the discount rate used in computing the present value of the minimum lease payments applied to the remaining balance of the obligation.
- .19 *A lessee that has a liability to a lessor under a capital lease shall remove the liability from its balance sheet when, and only when, it is extinguished (i.e., when the obligation specified in the lease is discharged or cancelled) (see FINANCIAL INSTRUMENTS, paragraphs 3856.A49-.A61).*
- .20 Contingent rentals shall be charged to expense as incurred.

Presentation of a capital lease

- .21 In order to distinguish between assets that the enterprise owns and those that it only has the right to use, assets leased under capital leases shall be presented separately. The related lease obligations shall be separated from other long-term obligations.
- .22 *Obligations related to leased assets shall be presented separately from other long-term obligations.*
- .23 *Any portion of lease obligations payable within a year out of current funds shall be included in current liabilities.*

Method of accounting for an operating lease

- .24 Because most operating leases are short term, charging lease rentals to expense on a straight-line basis over the lease term, even if not payable in such a manner, would normally result in recognition of the expense in a manner that is representative of the time pattern in which the user derives benefit from the leased property. However, circumstances may indicate that another basis is required to achieve this result.
- .25 *The terms of a renegotiated lease are interdependent with those of the original lease. On renegotiation, a lessee shall continue to account for the lease in accordance with the terms of the original lease contract until the original lease term expires. To the extent that the payments required under the renegotiated lease arrangement differ from those otherwise due under the original lease, the differences are considered to relate to the term of the lease extension.*
- .26 Payments under a residual value guarantee are included in lease rentals when it becomes likely that the lessee will be required to honour the guarantee because the estimated value of the property at the end of the lease term is less than the residual value guaranteed by the lessee.

- .27 Lease inducements are an inseparable part of the lease agreement and, accordingly, are accounted for as reductions of the lease expense over the term of the lease.
- .28 *Lease rentals under an operating lease shall be included in the determination of net income over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the time pattern of the user's benefit.*

ACCOUNTING TREATMENT BY A LESSOR

Method of accounting for a direct financing lease

- .29 Direct financing leases normally arise when a lessor acts as a financing intermediary between a manufacturer or dealer and a lessee. Such leases give rise to income in the form of finance income.
- .30 Finance income arising on a direct financing lease is composed of the difference between:
- the total minimum lease payments, net of any executory costs and related profit included therein, plus any unguaranteed residual value of the leased property accruing to the lessor; and
 - the cost or carrying amount, if different, of the leased property.
- .31 A lessor enters into a direct financing lease with the intention of earning a return on funds invested in the lease transaction. When assessing whether proposed terms of a lease will produce an acceptable return on the required investment, a lessor considers the pattern of cash flows associated with the lease transaction. In some instances, the pattern of cash flows will be significantly affected by the fact that income taxes will be reduced as a result of an investment tax credit and/or deferred as a result of capital cost allowances related to the leased property. When income tax elements that affect the cash flow are predictable with reasonable assurance, it may be appropriate to take these elements into consideration in accounting for income from the lease.
- .32 Deferral of income tax payments as a result of the lease is considered to be predictable with reasonable assurance when the following conditions are present:
- the lessor is reasonably assured of obtaining capital cost allowances on the leased property; and
 - there is reasonable assurance that the lessor will have sufficient taxable income to make use of the capital cost allowance on the leased property.
- .33 When income tax factors are taken into consideration in accounting for a direct financing lease, the lessor's initial and continuing investment in the lease, for purposes of income recognition, is the net of the balances of the following accounts:
- minimum lease payments receivable less any executory costs and related profit included therein;
 - the unguaranteed residual value of the lease property accruing to the lessor;
 - unearned finance income, after deducting initial direct costs, remaining to be allocated to income over the lease term;
 - the investment tax credit remaining to be allocated to income over the lease term; and
 - future income taxes as a result of the lease, when predictable with reasonable assurance.
- .34 When income tax factors are not taken into consideration in accounting for a direct financing lease, the lessor's initial and continuing investment in the lease, for purposes of income recognition, is the net balances of the accounts set out in paragraph 3065.33(a)-(c).
- .35 *When a lease is a direct financing lease, initial direct costs shall be expensed as incurred and a portion of unearned income equal to the initial direct costs shall be recognized in income in the same period. The remaining income shall be deferred and taken into income over the lease term to produce a constant rate of return on the investment in the lease.*
- .36 The estimated residual value is reviewed annually to determine whether a decline in its value has occurred. If the decline in value is other than temporary, the accounting for the lease transaction shall be revised using the changed estimate. The resulting reduction in the net investment in the lease is charged to income. An upward adjustment of the residual value is not made.
- Method of accounting for a sales-type lease**
- .37 Sales-type leases normally arise when a manufacturer or dealer uses leasing to effect a sale of its products. Such lease transactions give rise to two types of income: the initial profit or loss on the sale of the product at the inception of the lease and finance income over the lease term.
- .38 The sales revenue recorded at the inception of a sales-type lease is the present value of the minimum lease payments net of any executory costs and related profit included therein, computed at the interest rate implicit in the lease. The cost of sale recognized at the inception of the lease is the cost or carrying value, if different, of the leased property reduced by the present value of the unguaranteed residual accruing to the lessor, computed at the interest rate implicit in the lease.

- .39 Finance income arising from a sales-type lease is composed of the difference between:
- (a) total minimum lease payments, net of any executory costs and related profit included therein, plus any unguaranteed residual value of the leased property accruing to the lessor; and
 - (b) the aggregate of their present values.
- The discount rate for determining the present values is the interest rate implicit in the lease.
- .40 When it is appropriate to take income tax factors into consideration in accounting for a sales-type lease, the lessor's initial and continuing investment in a sales-type lease, for purposes of income recognition, is the net of the balances of the accounts set out in paragraph 3065.33(a)-(e).
- .41 When income tax factors are not taken into consideration in accounting for a sales-type lease, the lessor's initial and continuing investment for purposes of recognizing unearned finance income in the lease is the net balances of the accounts set out in paragraph 3065.33(a)-(c).
- .42 Initial direct costs are considered to be incurred in order to produce the sale; therefore, they are recognized as an expense at the inception of the lease.
- .43 *When a lease is a sales-type lease, a sale shall be recorded with the manufacturer's or dealer's profit or loss being recognized at the time of the transaction. Initial direct costs shall be expensed at the inception of the lease and unearned finance income shall be deferred and taken into income over the lease term to produce a constant rate of return on the investment in the lease.*
- .44 The estimated residual value is reviewed annually to determine whether a decline in its value has occurred. If the decline in value is other than temporary, the accounting for the lease transaction shall be revised using the changed estimate. The resulting reduction in the net investment in the lease is charged to income. An upward adjustment of the residual value is not made.
- .45 Providing it transfers substantially all the benefits and risks of ownership related to the leased property, from the lessor to the lessee, a renewal or an extension of an existing sales-type lease shall be classified as a direct financing lease since the manufacturer's or dealer's profit will have been recognized at the inception of the original lease.
- Impairment**
- .46 *At the end of each reporting period, an entity shall assess whether there are any indications that each direct financing, sales-type lease, operating lease receivables (the lease asset), or group of similar lease assets, is impaired. When there is an indication of impairment, an entity shall determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the lease asset or group of assets.*
- .47 Lease assets that are individually significant are assessed individually for impairment. Other lease assets are assessed for impairment either individually or grouped on the basis of similar credit risk characteristics. Group assessment might be appropriate when available information is not sufficient to permit identification of each of the individual assets within a group that is impaired, or there are numerous assets affected by the same factors. For example, an entity might collectively evaluate customers that operate in a particular industry or geographic region, or that share other identifiable common characteristics.
- .48 Indicators of impairment include:
- (a) significant financial difficulty of the lessee;
 - (b) a breach of contract, such as a default or delinquency in payment;
 - (c) the entity granting a concession to the lessee;
 - (d) it becoming probable that the lessee will enter bankruptcy or other financial reorganization; and
 - (e) a significant adverse change in the technological, market, economic or legal environment in which the lessee operates. (For example, a sharp decline in the price of a commodity may cause economic instability in the lessee's industry or have an adverse effect on other entities in a region that is dependent on the lessee's industry.)
- .49 *When an entity identifies a significant adverse change in the expected timing or amount of future cash flows from a lease asset, or group of similar lease assets, it shall reduce the carrying amount of the asset, or group of assets, to the highest of the following:*
- (a) *the present value of the cash flows expected to be generated by holding the lease asset, discounted using a current market rate of interest appropriate to the asset;*
 - (b) *the amount that could be realized by selling the lease at the balance sheet date; and*
 - (c) *the amount the entity expects to realize by exercising its rights to the leased property net of all costs necessary to exercise those rights.*

The carrying amount of the lease asset, or group of assets, shall be reduced directly or through the use of an allowance account. The amount of the reduction shall be recognized as an impairment loss in net income.

- .50 When the extent of impairment of a previously written down asset or group of assets decreases and the decrease can be related to an event occurring after the impairment was recognized (such as a return to profitability of the lessee), the previously recognized impairment loss shall be reversed to the extent of the improvement. The adjusted carrying amount of the lease asset, or group of assets, shall be no greater than the amount that would have been reported had the impairment not been recognized previously. The amount of the reversal shall be recognized in net income in the period the reversal occurs.

Presentation of a direct financing or sales-type lease

- .51 The result of these types of lease transactions is to create a long-term receivable, although the lessor may also hold an interest in the residual value of an asset under lease. As a consequence, the net investment in the lease is considered to be distinct from other assets and presented separately.
- .52 For purposes of statement presentation, the lessor's net investment in the lease includes:
- (a) the minimum lease payments receivable less any executory costs and related profit included therein; plus
 - (b) any unguaranteed residual value of the leased property accruing to the lessor; less
 - (c) unearned finance income remaining to be allocated to income over the lease term.
- .53 When income tax factors have been considered in accounting for a direct financing or sales-type lease, any unamortized investment tax credit shall either be deducted in computing the net investment in the lease or shown as a deferred credit. Future income taxes, if any, relating to the net investment in the lease are presented separately from the net investment in accordance with INCOME TAXES, paragraph 3465.81.
- .54 *The lessor's net investment in direct financing and sales-type leases shall be segregated between current and long-term portions in a classified balance sheet.*

Method of accounting for an operating lease

- .55 Rental revenue from an operating lease shall be recognized as income over the term of the lease as it becomes due. However, if rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased property is utilized.
- .56 When initial direct costs are associated with a specific lease agreement, the costs are applicable to all revenue earned during the lease term and shall be deferred and amortized over the lease term in proportion to the recognition of rental income.

Participation by a third party

- .57 The terms of either an assignment of lease payments due under an operating lease or a sale of property that is already, or that is intended to be, subject to an operating lease may result in the assignee or purchaser being given an effective guarantee that the investment will be recovered. For example, this may be evidenced by the fact that the terms of the transaction provide that in the case of default by the lessee or termination of the lease, the seller must reacquire the property, substitute an existing lease or give priority to securing a replacement lessee or buyer under a remarketing agreement. When the substance of a transaction is such that the purchaser looks to the seller rather than to the property or lease in order to recover his investment, the transaction is regarded as a secured loan by both parties, as the seller or assignor has retained substantial risks of ownership.
- .58 *An assignment of lease payments due under an operating lease or a sale of property that is already, or that is intended to be, subject to an operating lease shall be accounted for as a loan whenever the assignor or seller retains substantial risks of ownership in connection with the leased property.*
- .59 When a sale of property that is already, or that is intended to be, subject to an operating lease is classified as a secured loan, the seller shall record the proceeds of sale as a loan. The interest rate applicable to the loan is that which an unrelated lender would negotiate with the lessor for a loan under similar terms and conditions. Until the loan is paid, the seller records as revenue rental payments made by the lessee, even if such rentals are paid directly to the third party purchaser, and record as interest expense an appropriate portion of each rental payment with the remainder reducing the amount of the loan. The asset is depreciated over the amortization period of the loan. The assignment by the lessor of lease payments due under an operating lease shall be accounted for as a loan.
- .60 A sale of property already subject to a sales-type or direct financing lease or an assignment of lease payments due under a sales-type or direct financing lease does not negate the original accounting treatment of the lease.
- SUBLEASES**
- .61 When leased property is subleased by the original lessee to a third party, the sublease is evaluated by both parties in accordance with paragraphs 3065.09-.10. There is no effect on the accounting treatment of the obligation under the original lease.

SALE-LEASEBACK TRANSACTION

- .62 A sale-leaseback transaction involves the sale of property with the purchaser concurrently leasing the same property back to the seller.
- .63 *In a sale-leaseback transaction, the lease shall be accounted for as a capital, direct financing or operating lease, as appropriate, by the seller-lessee and by the purchaser-lessor.*
- .64 In view of the interdependence of the terms and the inability to objectively and practically separate the sale and lease, any profit or loss arising on the sale is generally deferred and taken to income over the lease term. However, when the leaseback is of a portion of the remaining use of the property sold, it may be possible to separate the accounting aspects of the terms of the sale and the lease. The "portion" may be a part of the property, such as one floor of an office tower, or may consist of a portion of the property's remaining economic life, such as three years of an estimated life of 10 years. In substance, such a leaseback is not a lease of the same property as that sold to the purchaser-lessor.
- .65 *Except as noted in paragraph 3065.69, when the leaseback is classified as a capital lease, any profit or loss arising on the sale shall be deferred and amortized in proportion to the amortization of the leased asset except for leases involving land only, in which case it shall be amortized over the lease term on a straight-line basis.*
- .66 *Except as noted in paragraph 3065.69, when the leaseback is classified as an operating lease, any profit or loss arising on the sale shall be deferred and amortized in proportion to rental payments over the lease term.*
- .67 When the seller-lessee retains the right to only a minor portion of the property sold, the sale and leaseback is accounted for as separate transactions based on their respective terms. The entire gain or loss is included in the determination of net income at the date of the sale unless the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease. In these circumstances, an appropriate amount is deferred or accrued, by adjusting the profit or loss on the sale, and amortized to adjust those rentals to a reasonable amount. If the present value of the minimum lease payments represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.
- .68 When the seller-lessee retains the right to more than a minor portion of the property but less than substantially all of the property, the amount of the gain or loss included in the determination of net income immediately is equal to the excess, if any, of the gain on sale over:
- (a) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease; or
 - (b) the recorded amount of the leased asset, if the leaseback is classified as a capital lease.
- .69 *When, at the time of the sale-leaseback transaction, the fair value of the property is less than its carrying value, the difference shall be recognized as a loss immediately.*

LEASES INVOLVING LAND AND BUILDINGS

- .70 Under a capital lease, the terms of which allow ownership to pass or provide for a bargain purchase option, a lessee shall capitalize the land separately from building(s), in proportion to their fair values at the inception of the lease.
- .71 When a lease involving land and building(s) does not contain terms that allow ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is minor in relation to the total fair value of the leased property, the land and the building(s) are considered a single unit for the purposes of classification of the lease. The economic life of the building(s) is considered the economic life of the unit.
- .72 When a lease involving land and building(s) does not contain terms that allow the ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is significant in relation to the total fair value of the leased property, the land and building(s) are considered separately for purposes of classification. The lessee and lessor allocate the minimum lease payments between the land and building(s) in proportion to their fair values. Both parties classify the portion of the lease applicable to land as an operating lease.

DISCLOSURE

Capital lease — lessee

- .73 *For each major category of leased property, plant and equipment, there shall be disclosure of:*
- (a) cost;
 - (b) accumulated amortization, including the amount of any write-downs; and
 - (c) the amortization method used, including the amortization period or rate.
- .74 *For an obligation under a capital lease, an entity shall disclose:*
- (a) the interest rate;

- (b) the maturity date;
 - (c) the amount outstanding; and
 - (d) if the leases are secured, the fact that they are secured.
- .75 Interest expense related to lease obligations shall be disclosed separately, or as part of interest on long-term indebtedness.
- .76 The aggregate amount of payments estimated to be required in each of the next five years to meet repayment, sinking fund or retirement provisions shall be disclosed.
- Operating lease — lessee**
- .77 Disclosure shall be made of the future minimum lease payments, in the aggregate and for each of the five succeeding years under operating leases. The nature of other commitments under such leases shall also be described. Leases with an initial term of one year or less may be excluded from this disclosure requirement.
- Direct financing or sales-type lease — lessor**
- .78 The lessor's net investment in direct financing and sales-type leases shall be disclosed along with the interest rates implicit in the leases.
- .79 An entity shall disclose:
- (a) the carrying amount of impaired direct financing and sales-type leases and the amount of any related allowance for impairment; and
 - (b) the amount of any impairment loss or reversal of a previously recognized impairment loss that is included in net income.
- Operating lease — lessor**
- .80 Disclosure shall be made of the cost of property, plant and equipment held for leasing purposes and the amount of accumulated amortization.
- .81 An entity shall disclose:
- (a) the amount of any related allowance for impairment; and
 - (b) the amount of any impairment loss or reversal of a previously recognized impairment loss that is included in net income.
- COVID-19-related rent concessions – lessee and lessor**
- .81A An enterprise that grants or receives rent concessions and uses the practical expedient in accordance with paragraph 3065.11A shall disclose that it has applied the expedient.
- .81B Where an enterprise has used the practical expedient for some but not all leases that meet the conditions specified in paragraph 3065.11A, that fact and the reasons therefor shall be disclosed.
- .81C For rent concessions disclosed in accordance with paragraph 3065.81A and that result in deferrals of lease payments, an enterprise shall disclose, on an aggregate basis, the carrying amount, if any, of lease payables and lease receivables recognized in accordance with paragraph 3065.11B.
- .81D For rent concessions disclosed in accordance with paragraph 3065.81A and that result in the total payments required to be less than the total payments required by the original lease contract, an enterprise shall disclose, on an aggregate basis, the total amount recognized in net income in the reporting period in accordance with paragraph 3065.11C.
- EFFECTIVE DATE AND TRANSITION**
- .82 Except as specified in paragraphs 3065.83-86, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.
- .83 Amendments to paragraphs 3065.79 and 3065.81, issued in October 2015, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2016. Earlier application is permitted.
- .84 Amendments to paragraph 3065.81(a), issued in July 2017, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2018. Earlier application is permitted.
- .85 Amendments to paragraph 3065.11 and new paragraphs 3065.11A-11C and 3065.81A-81D, issued in November 2020, apply to annual financial statements relating to fiscal years ending on or after December 31, 2020. Earlier application is permitted, including in financial statements not yet authorized for issue, so that the practical expedient is available for COVID-19-related rent concessions granted or received in 2020. An enterprise applies these amendments retrospectively, as defined in ACCOUNTING CHANGES, paragraph 1506.05(d).

.86 Amendments to paragraph 3065.11A, issued in December 2021, apply to annual financial statements relating to fiscal years ending on or after December 31, 2021. Earlier application is permitted, including in financial statements not yet authorized for issue. An enterprise applies these amendments retrospectively, as defined in ACCOUNTING CHANGES, paragraph 1506.05(d).

ILLUSTRATIVE EXAMPLES

ACCOUNTING TREATMENT FOR LEASES BY THE LESSEE AND THE LESSOR

This material is illustrative only.

These examples illustrate how the accounting treatment specified in this Section might be applied in particular situations. Matters of principle relating to particular situations should be decided in the context of this Section.

Example 1 — Capital lease and sales-type lease

Example 2 — Capital lease and direct financing lease

Example 3 — Accounting for sale of a property with a portion leased back under a capital lease

Example 4 — Accounting for sale of a property with a portion leased back under an operating lease

Example 5 — Lessee's accounting on renegotiation of an operating lease

Example 1 — Capital lease and sales-type lease

This example illustrates the following:

When a lease transfers substantially all the benefits and risks incident to ownership of the leased property:

- (a) the lessee will treat the transaction as an acquisition of an asset and an undertaking of an obligation; and
- (b) the lessor will treat the transaction as a sale when the fair value of the leased property is not equal to the lessor's carrying value of the property.

It also brings out the following points:

- (a) the lessee uses the interest rate implicit in the lease when it is known and it is lower than the lessee's rate for incremental borrowing;
- (b) the effect of a bargain purchase option on the transaction; and
- (c) the lessee amortizes depreciable property under capital lease over its economic life when there is reasonable assurance that the lessee will obtain ownership to the property as a result of the lease.

In this example the following circumstances are assumed:

- (1) On January 1, 2X07 Lessee Ltd. entered into an agreement to lease a machine from Lessor Ltd.; the details surrounding the agreement are as follows:

Lessor Ltd.'s carrying value of machine	\$225,000
Fair value of machine	\$250,000
Economic life of machine	10 years
Lease term	6 years
Rental payments (at beginning of each year)	\$53,000
Initial direct costs (commissions)	\$2,500
Residual value at end of lease term	\$40,000
Lessee Ltd.'s rate for incremental borrowing	13%

The lease contains a clause allowing ownership of the equipment to pass to Lessee Ltd. at the end of the lease term upon payment of \$2,080 (bargain purchase option).

- (2) There are no abnormal risks associated with the collection of lease payments from Lessee Ltd.

- (3) There are no additional unreimbursable costs to be incurred by Lessor Ltd. in connection with the leased machine.
- (4) All executory costs are paid directly by Lessee Ltd.
- (5) Lessor Ltd. does not take tax factors into consideration when recognizing income from the lease.

Lessee Ltd.
Balance Sheet (extracts)

As at December 31	<u>2X07</u>	<u>2X08</u>
ASSETS		
Equipment under capital lease (Note X)		
	\$225,000	\$200,000
LIABILITIES		
Current:		
Obligation under capital lease	53,000	53,000
Non-current:		
Obligation under capital lease (Note Y)	218,670	183,894
Current portion	<u>(53,000)</u>	<u>(53,000)</u>
	\$165,670	\$130,894
	=====	=====

Note X:

The following is an analysis of equipment under capital lease:

	<u>Dec. 31, 2X07</u>	<u>Dec. 31, 2X08</u>
Equipment (cost)	\$250,000	\$250,000
Accumulated amortization	<u>(25,000)</u>	<u>(50,000)</u>
	\$225,000	\$200,000
	=====	=====

The equipment under the capital lease is amortized on a straight-line basis over its economic life of 10 years.

The amount of amortization charged to expense — 2X07 — \$25,000 and 2X08 — \$25,000.

Note Y:

The following is a schedule of future minimum lease payments under the capital lease expiring December 31, 2X12 together with the balance of the obligation under capital lease.

Year ending December 31	<u>2X07</u>	<u>2X08</u>
2X08	\$53,000	\$ —
2X09	53,000	53,000

2X10		53,000	53,000
2X11		53,000	53,000
2X12		<u>55,080</u>	<u>55,080</u>
Total minimum lease payments		267,080	214,080
Amount representing interest at 11%		(48,410)	(30,186)
Balance of the obligation		\$218,670	\$183,894

Journal entries	Lessee Ltd. Journal Entries for Years 1, 2, 3 and 6 of Lease													
	Inception of lease <u>1/1/07</u>		End of first year <u>12/31/07</u>		Beginning of second year <u>1/1/08</u>		End of second year <u>12/31/08</u>		Beginning of third year <u>1/1/09</u>		End of third year <u>12/31/09</u>		Beginning of sixth year <u>1/1/12</u>	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
1. Equipment under capital lease	250,000													
	Obligation under capital lease	250,000												
	(To record capital lease)													
2. Obligation under capital lease		53,000												
	Cash	53,000												
	(To record initial lease payment)													
3. Interest expense			21,670				18,224				14,398			
	Obligation under capital lease		21,670				18,224				14,398			
	(To set up interest expense at end of year)													
4. Obligation under capital lease				53,000				53,000			53,000		53,000	
	Cash			53,000				53,000			53,000		53,000	

(To record lease
payment)

- ## 5. Obligation under capital lease

Interest expense

Cash

(To record payment
of bargain purchase
option)

Balance at beginning	Balance of obligation		Interest expense calculation				
	Payment	Interest	Reduction of principal	Balance at end	Balance of obligation	Interest factor	Interest expense
\$250,000	\$53,000	\$ —	\$53,000	\$197,000	\$197,000	x 11%	= \$21,670
197,000	53,000	21,670	31,330	165,670	165,670	x 11%	= 18,224
165,670	53,000	18,224	34,776	130,894	130,894	x 11%	= 14,398
130,894	53,000	14,398	38,602	92,292	92,292	x 11%	= 10,152
92,292	53,000	10,152	42,848	49,444	49,444	x 11%	= 5,439
49,444	53,000	5,439	47,561	1,883	1,883	x 11%	= 207
1,883	2,080	197 *	1,883	—	—		

* correction of \$10 for rounding

Explanation — Lessee Ltd.

Lessee Ltd. classifies the lease as a capital lease since there is evidence that substantially all the risks and benefits incident to ownership of the machine have been transferred from Lessor Ltd. to Lessee Ltd. The terms of the lease provide the following evidence in this regard:

- (a) the purchase option in the lease is such that there is reasonable assurance that Lessee Ltd. will exercise the option at the option date and obtain ownership of the machine; and
 - (b) the present value of the net minimum lease payments covers 100 percent of the machine's fair value at the inception of the lease.

Present Value of Net Minimum Lease Payments

Factor for present worth of \$1 payable in 5 yearly payments at 11% (a) per year	3.696
Factor for initial payment no interest element	<u>1.000</u>
	4.696
Yearly payments	x \$53,000
	\$248,888

Factor for present worth of \$1 due in 6 years at 11% (a) per year	.535
Bargain purchase option	x \$ 2,080 <u>1,112</u>
Present value	\$250,000 (b)
	=====

- (a) It is assumed that Lessee Ltd. knows the interest rate implicit in the lease.
- (b) If the fair value of the machine is less than the present value of the net minimum lease payments, the asset and obligation would be recorded at the fair value. This would result in using an interest rate greater than the interest rate implicit in the lease.

Lessor Ltd.
Balance Sheet (extracts)

As at December 31	<u>2X07</u>	<u>2X08</u>
ASSETS		
Current:		
Net investment in lease (Note X)	\$34,776	\$38,602
Non-current:		
Net investment in lease (Note Y)	218,670	183,894
Current portion	<u>(34,776)</u>	<u>(38,602)</u>
	\$183,894	\$145,292
	=====	=====

Note X:

Finance income related to the sales-type lease is recognized in a manner that produces a constant rate of return on the investment in the lease. The investment in the lease for purposes of income recognition is composed of net minimum lease payments and unearned finance income.

Note Y:

The company's net investment in lease includes the following:

	<u>Dec. 31, 2X07</u>	<u>Dec. 31, 2X08</u>
Total minimum lease payments receivable	\$267,080	\$214,080
Unearned income	<u>(48,410)</u>	<u>(30,186)</u>
	\$218,670	\$183,894
	=====	=====

Future minimum lease payments receivable under the sales-type lease are as follows:

Year ending December 31	<u>2X07</u>	<u>2X08</u>

2X08		\$ 53,000	
2X09		53,000	\$ 53,000
2X10		53,000	53,000
2X11		53,000	53,000
2X12		<u>55,080</u>	<u>55,080</u>
		\$267,080	\$214,080
		=====	=====

Explanation — Lessor Ltd.

Lessor Ltd. would classify the lease as a sales-type lease since there is evidence that substantially all the risks and benefits incident to ownership of the machine have been transferred to Lessee Ltd. and, at the inception of the lease, the fair value of the machine is greater than its carrying value in the accounts of Lessor Ltd. The evidence concerning the transfer of risks and benefits is as follows:

- (a) the purchase option in the lease is such that there is reasonable assurance, at the inception of the lease, that Lessee Ltd. will exercise the option and obtain title to the machine;
- (b) the present value of net minimum lease payments covers 100 percent of the machine's fair value at the inception of the lease;
- (c) the risk associated with the collection of rental payments from Lessee Ltd. is normal when compared with the collection risks associated with similar receivables; and
- (d) there are no significant future unreimbursable costs to be incurred by Lessor Ltd. in connection with the leased equipment.

Lessor Ltd. Journal Entries for Years 1, 2, 3 and 6 of the Lease

	Inception of lease 1/1/07		End of first year 12/31/07		Beginning of second year 1/1/08		End of second year 12/31/08		Beginning of third year 1/1/09		End of third year 12/31/09		Beginning of sixth year 1/1/12	
Journal entries	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
1. Minimum lease payments receivable	320,080													
Sales		250,000												
Unearned income		70,080												
Cost of sale	225,000													
Equipment inventory		225,000												
Commission expense	2,500													
Cash		2,500												
(To record sale of property under a sales-type lease)														
2. Cash	53,000				53,000				53,000				53,000	

Minimum lease payments receivable	53,000	53,000	53,000	53,000
(To record receipt of lease payment)				
3. Unearned income	21,670	18,224	14,398	
Finance income	21,670	18,224	14,398	
(To record income earned on sales-type lease)				

<u>Lessor's investment in the lease for purposes of income recognition</u>							<u>Interest income</u>
<u>Minimum lease payments receivable</u>	<u>Unearned income</u>	<u>Investment in lease at beginning of year</u>	<u>Lease payment</u>	<u>Interest income</u>	<u>Reduction of investment in lease</u>	<u>Investment in lease</u>	<u>Balance of obligation at beginning of period</u>
1/1/07	\$320,080	\$70,080	\$250,000	\$53,000	\$ —	\$53,000	\$197,000
12/31/07	267,080	70,080	197,000	—	21,670	—	197,000
12/31/08	214,080	48,410	165,670	53,000	18,224	34,776	130,894
12/31/09	161,080	30,186	130,894	53,000	14,398	38,602	92,292
12/31/10	108,080	15,788	92,292	53,000	10,152	42,848	49,444
12/31/11	55,080	5,636	49,444	53,000	5,439	47,561	1,883
12/31/12	2,080	197	1,883	2,080	197 *	1,881	—
							1,883
							x 11% = \$207

* correction of \$10 for rounding

Example 2 — Capital lease and direct financing lease

This example illustrates the following:

When a lease transfers substantially all the benefits and risks incident to ownership of the leased property:

- (a) the lessee will treat the transaction as an acquisition of an asset and an undertaking of an obligation; and
- (b) the lessor will treat the transaction as a financing when the fair value of the leased property is equivalent to the lessor's carrying value of the property.

It also brings out the following points:

- (a) the effect of a guarantee of the residual value on the transaction; and
- (b) the lessee amortizes depreciable property under a capital lease over the lease term unless there is reasonable assurance that the lessee will obtain ownership to the property.

In this example the following circumstances are assumed:

(1) On January 1, 2X07 Lessee Ltd. entered into an agreement to lease a truck from Lessor Ltd.; the details surrounding the agreement are as follows:

Lessor Ltd.'s carrying value of truck	\$20,691
Fair value of truck	\$20,691
Economic life of truck	5 years
Lease term	3 years
Rental payments (at beginning of each month)	\$620
Executory costs and related profit, included in rental payments each month	\$20
Lessee Ltd. guarantees Lessor Ltd. that at the end of the lease term Lessor Ltd. will realize \$3,500 from selling the truck	
Lessee rate for incremental borrowing	12%

- (2) There are no abnormal risks associated with the collection of lease payments from Lessee Ltd.
- (3) There are no additional unreimbursable costs to be incurred by Lessor Ltd. in connection with the leased truck.
- (4) At the end of the lease term, Lessor Ltd. sells the truck for \$3,200.
- (5) Lessee Ltd. knows the interest rate implicit in the lease.
- (6) Lessor Ltd. does not take tax factors into consideration when recognizing income from the lease.
- (7) Lessee Ltd. knows the amount of executory costs and related profit thereon included in the minimum lease payments.

Lessee Ltd.
Balance Sheet (extracts)

As at December 31	<u>2X07</u>	<u>2X08</u>
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ASSETS

Equipment under capital lease (Note X)	\$14,961	\$9,231
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LIABILITIES

Current:

Obligation under capital lease (Note Y)	5,704	9,927
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Non-current:

Obligation under capital lease (Note Y)	15,631	—
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Current portion	(5,704)	—
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Note X:

The following is an analysis of equipment under capital lease:

	Dec. 31 2X07	Dec. 31 2X08
Equipment (cost)	\$20,691	\$ 20,691
Accumulated amortization	<u>(5,730)</u>	<u>(11,460)</u>
	\$14,961	\$ 9,231
	=====	=====

Leased property is amortized on a straight-line basis over the lease term to its residual value (i.e., \$3,500).

The amount of amortization charged to expense: 20X7 — \$5,730 and 20X8 — \$5,730.

Note Y:

The following is a schedule of future minimum lease payments under a capital lease expiring December 31, 2X09, together with the present balance of the obligation under a capital lease.

Year ending December 31	<u>2X07</u>	<u>2X08</u>
2X08	\$ 7,440	\$ —
2X09	<u>10,940</u>	<u>10,940</u>
	18,380	10,940
Amount representing executory costs	(480)	(240)
Amount representing interest (12%)	<u>(2,269)</u>	<u>(773)</u>
Balance of the obligation	\$15,631	\$ 9,927
	=====	=====

Explanation — Lessee Ltd.

Lessee Ltd. would classify the lease as a capital lease since there is evidence that substantially all the risks and benefits incident to ownership of the truck have been transferred from Lessor Ltd. to Lessee Ltd. The terms of the lease provide the following evidence in this regard:

- (a) the present value of the net minimum lease payments covers 100 percent of the truck's fair value at the inception of the lease.

Present Value of Net Minimum Lease Payments

Factor for present worth of \$1 payable in 35 periodic payments at 1%	29.409	
Factor for initial payment no interest element	<u>1.000</u>	
	30.409	
Periodic payments	<u>x \$ 600</u>	\$18,245
Factor for present worth of \$1 due at the end of period 36 @ 1%	.6989	
Residual value	<u>x \$3,500</u>	<u>2,446</u>
	\$20,691	
	=====	

Lessee Ltd. Journal Entries								
	Inception of lease <u>1/1/07</u>		End of first year <u>12/31/07</u>		End of second year <u>12/31/08</u>		End of third year <u>12/31/09</u>	
Journal entries	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
1. Property under capital lease	20,691							
Obligation under capital lease		20,691						
(To record capital lease commitment)								
2. Obligation under capital lease			5,215		5,802		6,462	
Interest expense			1,985		1,398		738	
Insurance expense			240		240		240	
Cash				7,440		7,440		7,440
(To record rental payment for year)								
3. Amortization expense			5,730		5,730		5,731	
Accumulated amortization				5,730		5,730		5,731
(To record amortization for the year)								
4. Interest expense			155		98			
Obligation under capital lease				155		98		
(To record interest payable at end of year)								
5. Obligation under capital lease						3,465		
Interest expense						35		
Property under capital lease							3,500	
Loss on realization of residual value					300			

Cash		300
(To record liquidation of lease and loss on residual value)		

Lessor Ltd.
Balance Sheet (extracts)

As at December 31	<u>2X07</u>	<u>2X08</u>
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ASSETS

Current:

Net investment in lease	\$5,704	\$ 9,927
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Non-current:

Net investment in lease (Note Y)	15,631	—
Current portion	(5,704)	—

Note X:

Finance income related to the direct financing lease is recognized in a manner that produces a constant rate of return on the investment in the lease. The investment in the lease for purposes of income recognition is composed of net minimum lease payments and unearned finance income.

Note Y:

The company's net investment in lease includes the following:

	<u>Dec. 31, 2X07</u>	<u>Dec. 31, 2X08</u>
Total minimum lease payments receivable:		
2X08	\$ 7,440	\$ —
2X09	<u>10,940</u>	<u>10,940</u>
	\$18,380	\$10,940
Unearned income	(2,269)	(773)
Portion of leased payments representing executory costs	<u>(480)</u>	<u>(240)</u>
	\$15,631	\$ 9,927
	=====	=====

Explanation — Lessor Ltd.

Lessor Ltd. would classify the lease as a direct financing lease since there is evidence that substantially all the risks and benefits of ownership of the truck have been transferred to Lessee Ltd. and the fair value of the truck is the same as its carrying value to Lessor Ltd. at the inception of the lease. The evidence concerning the transfer of risk and benefits is as follows:

- (a) the present value of net minimum lease payments covers 100 percent of the truck's fair value at the inception of the lease;
- (b) the risk associated with the collection of rental payments from Lessee Ltd. is normal when compared with the collection risks associated with similar receivables; and
- (c) there are no significant future unreimbursable costs to be incurred by Lessor Ltd. in connection with the leased truck.

Lessor Ltd. Journal Entries

Journal entries	Inception of lease <u>1/1/07</u>		End of first year <u>12/31/07</u>		End of second year <u>12/31/08</u>		End of third year <u>12/31/09</u>	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
1. Minimum lease payments receivable		25,100						
Unearned finance income			4,409					
Equipment held for leasing purposes			20,691					
(To record direct financing lease)								
2. Cash			7,440		7,440		7,440	
Minimum lease payments receivable				7,200		7,200		7,200
Insurance expense				240		240		240
Unearned finance income			2,140		1,496		773	
Finance income				2,140		1,496		773
(To record rental payments for period)								
3. Cash						3,500		3,500
Minimum lease payments receivable								
(To record realization of residual value)								

Example 3 — Accounting for sale of a property with a portion leased back under a capital lease

The following facts are assumed:

An enterprise sells an existing 20-storey office tower. At the same time, the seller leases back three floors of the office tower, estimated to be approximately 15 percent of the total rental value of the office tower, for 20 years, which is substantially all of the remaining life of the building. Pertinent data are:

Sales price of the office tower	\$5,000,000
Carrying value of the office tower	\$1,000,000
Monthly rental called for by leaseback	\$8,250
Interest rate implicit in the lease	12%
The leased asset would be accounted for as a capital lease pursuant to the 75 percent economic life criterion in paragraph 3065.06(b). The seller-lessee would compute the gain to be recognized as follows:	
Gain on the sale	\$4,000,000
Recorded amount of the leased asset (capital lease)	<u>\$749,260</u>
Gain to be recognized	\$3,250,740
	=====

The deferred gain of \$749,260 would be amortized in proportion to the amortization of the leased asset over the term of the lease.

Example 4 — Accounting for sale of a property with a portion leased back under an operating lease

The following facts are assumed:

An enterprise sells an aircraft with an estimated remaining economic life of 20 years. At the same time, the seller leases back the aircraft for 10 years. Pertinent data are:

Sales price of the aircraft	\$ 2,000,000
Carrying value of the aircraft	\$300,000
Monthly rental under the leaseback	\$22,000
Interest rate implicit in the lease	12%
The leaseback does not meet any of the criteria for classification as a capital lease; hence, it would be classified as an operating lease. The seller-lessee would compute the gain to be recognized on the sale as follows:	
Gain on the sale	\$1,700,000
Present value of operating lease rental (\$22,000 for 120 months @ 12%)	<u>\$1,533,411</u>
Gain to be recognized	\$ 166,589
	=====

The deferred gain of \$1,533,411 would be amortized over the lease term.

Example 5 — Lessee's accounting on renegotiation of an operating lease

This example illustrates how a lessee would account for a revised lease arrangement and the related costs upon renegotiation of an operating lease.

A lessee renegotiates the terms of an operating lease prior to the end of the original lease term. The lessee currently leases property under a five-year operating lease arrangement, entered into three years ago, whereby the lessee pays an annual rental of \$25,000.

Immediately prior to the end of Year 3, the lessee enters into a revised operating lease arrangement for the same property, covering both the period to the end of the original lease term and an additional period of five years.

A new payment schedule of \$12,857 per annum from Years 4 to 10 is agreed upon. The lessee also makes a \$5,000 payment on renegotiation at the end of Year 3.

	<u>Contractual terms — Original lease arrangement</u>	<u>Cash flows — Revised lease arrangements</u>	<u>Accounting recognition of lease expenses</u>
Year 1	\$25,000	\$25,000	\$25,000
Year 2	25,000	25,000	25,000
Year 3	25,000	30,000 (a)	25,000
Year 4	25,000	12,857	25,000
Year 5	25,000	12,857	25,000
Year 6		12,857	9,000
Year 7		12,857	9,000
Year 8		12,857	9,000
Year 9		12,857	9,000
Year 10		<u>12,858</u>	<u>9,000</u>
Total		\$170,000	\$170,000
		=====	=====

(a) Includes \$5,000 payment on renegotiation.

The lease expense for the term of the lease extension is determined as follows:

Rental payments (\$12,857 x 5)	\$64,286
Reduction in payments in Years 4 and 5 (\$25,000 – \$12,857) x 2	(24,286)
Initial payment	<u>5,000</u>
	\$45,000
	=====
Annual expense (45,000 ÷ 5)	\$ 9,000
	=====

The payments under the revised arrangements, in Years 4 and 5 are different from those under the original lease terms. The reduction in the payments of \$24,286 represents an inducement to extend the lease.

The initial payment on renegotiation of \$5,000 payable in Year 3 is considered to be a cost of extending the term of the lease and is, therefore, recognized as an asset, and amortized over the term of the lease extension.

The lease expense in Years 4 and 5 remains at \$25,000 per annum, in accordance with the original lease.

DECISION TREES

These Decision Trees are illustrative only.

Decision Tree 1 — Classification of a lease — lessee

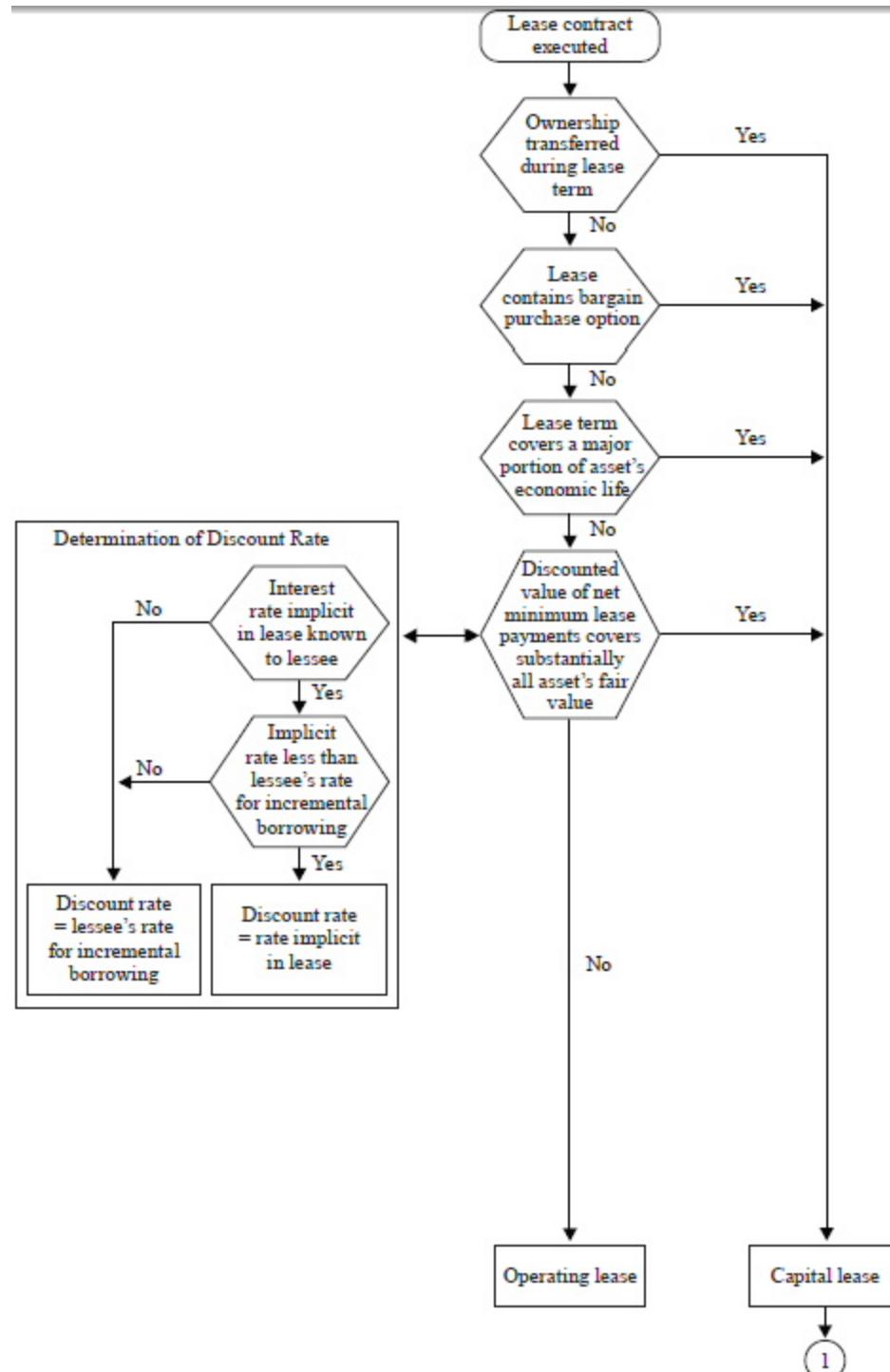
Decision Tree 2 — Accounting for a capital lease

Decision Tree 3 — Classification of a lease — lessor

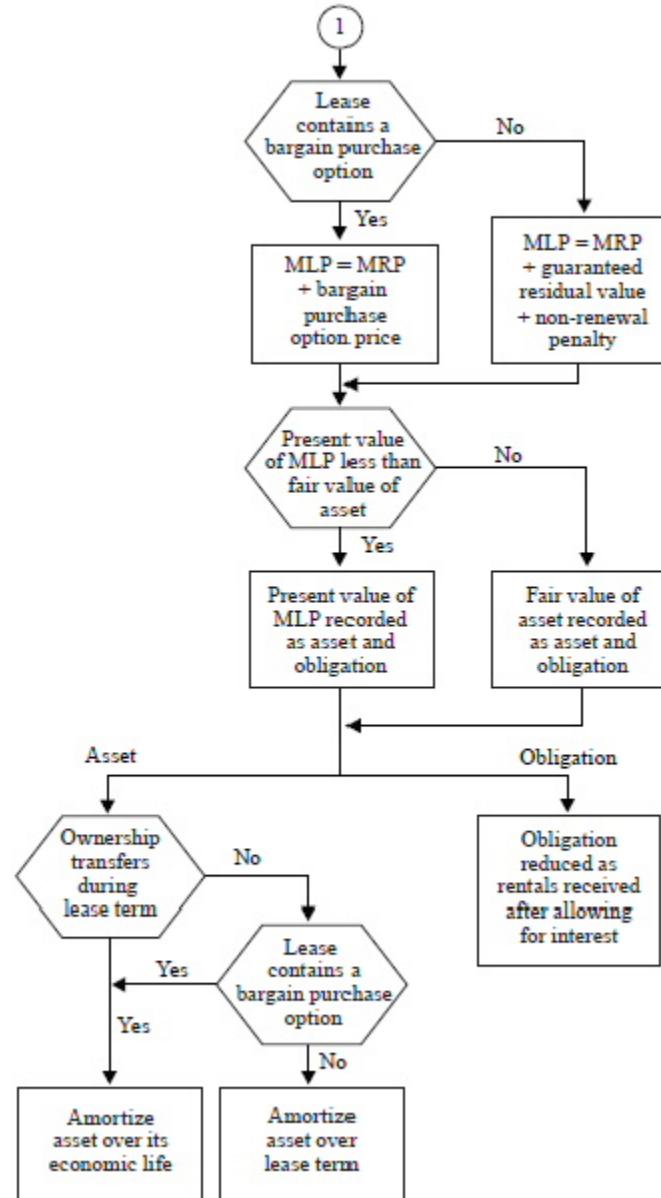
Decision Tree 4 — Accounting for a sales-type lease

Decision Tree 5 — Accounting for a direct financing lease

Decision Tree 1 — Classification of a lease — lessee



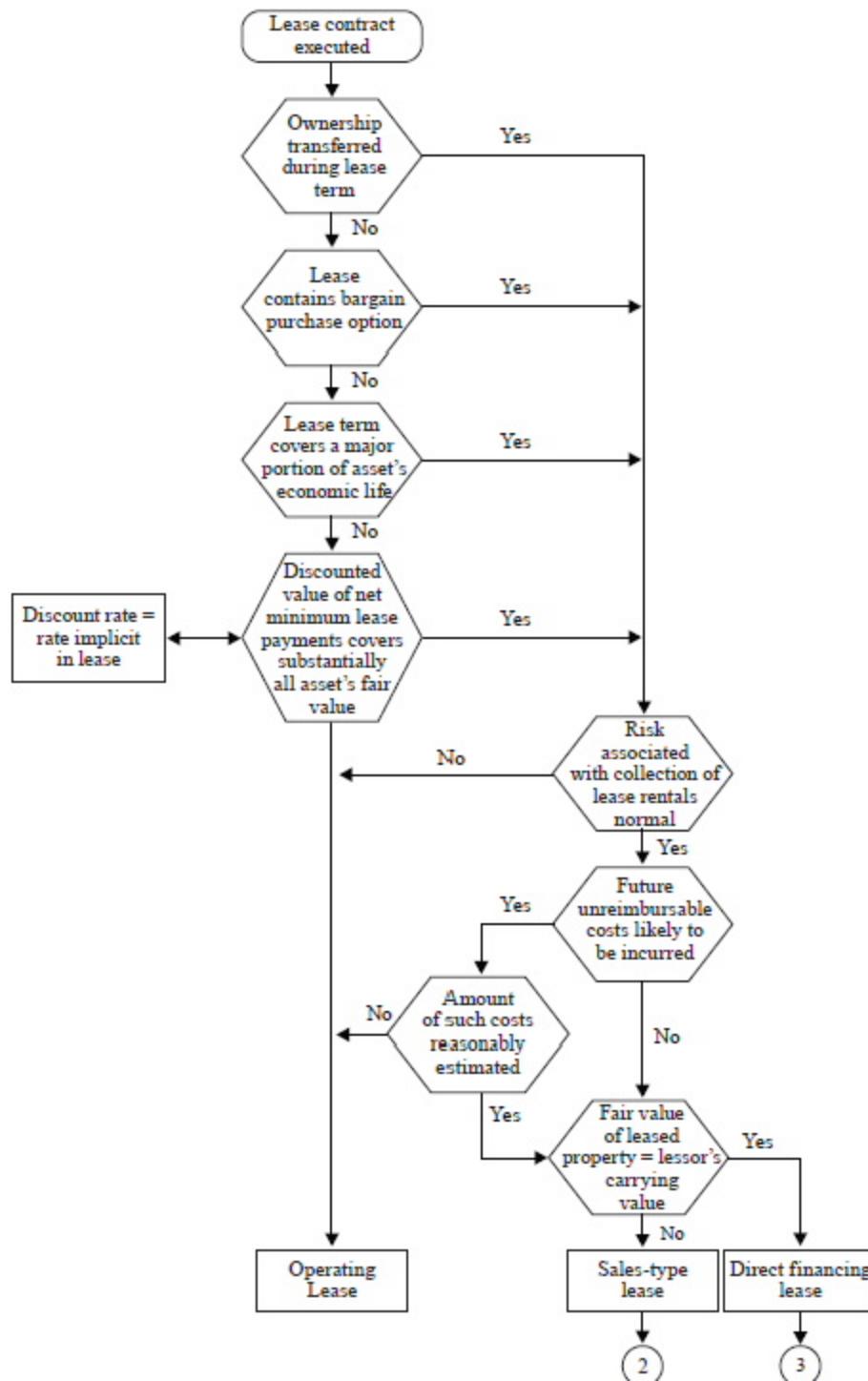
Decision Tree 2 — Accounting for a capital lease



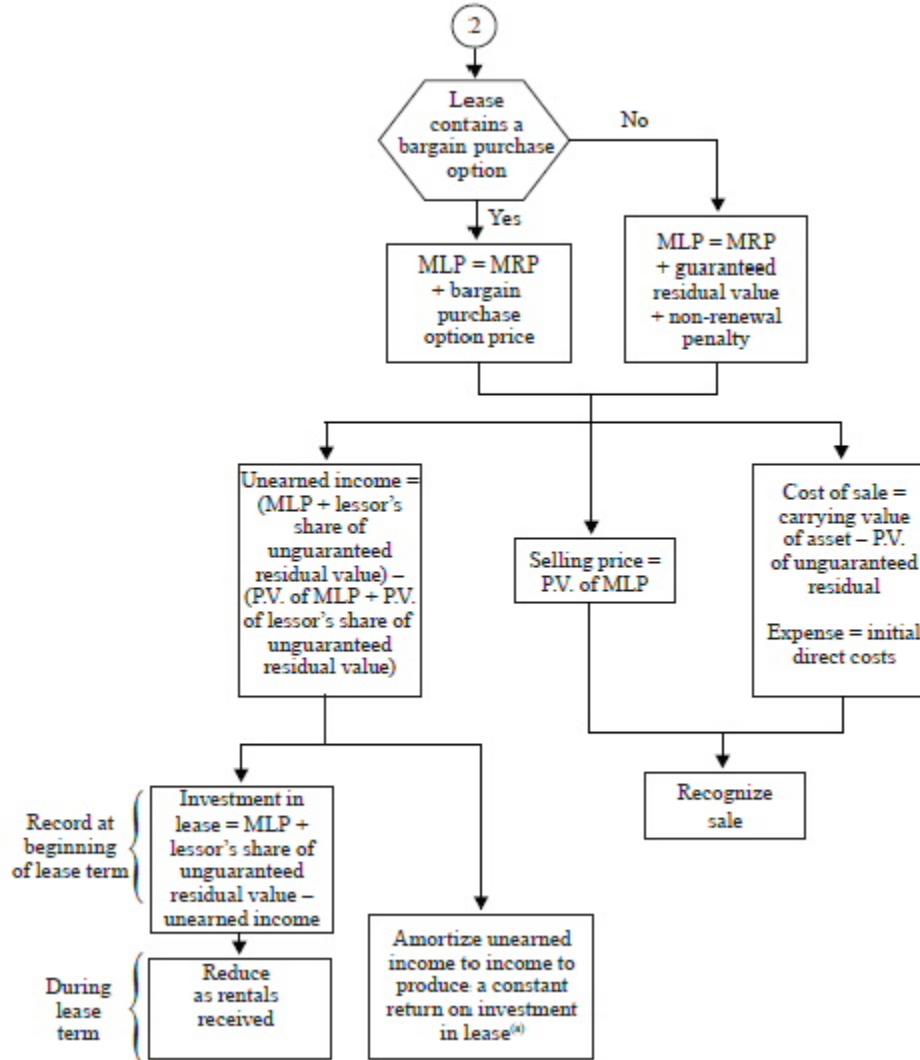
MLP = Net Minimum lease payments

MRP = Net minimum rental payments called for over the lease term

Decision Tree 3 — Classification of a lease — lessor



Decision Tree 4 — Accounting for a sales-type lease



MLP = Net minimum lease payments

MRP = Net minimum rental payments called for over the lease term

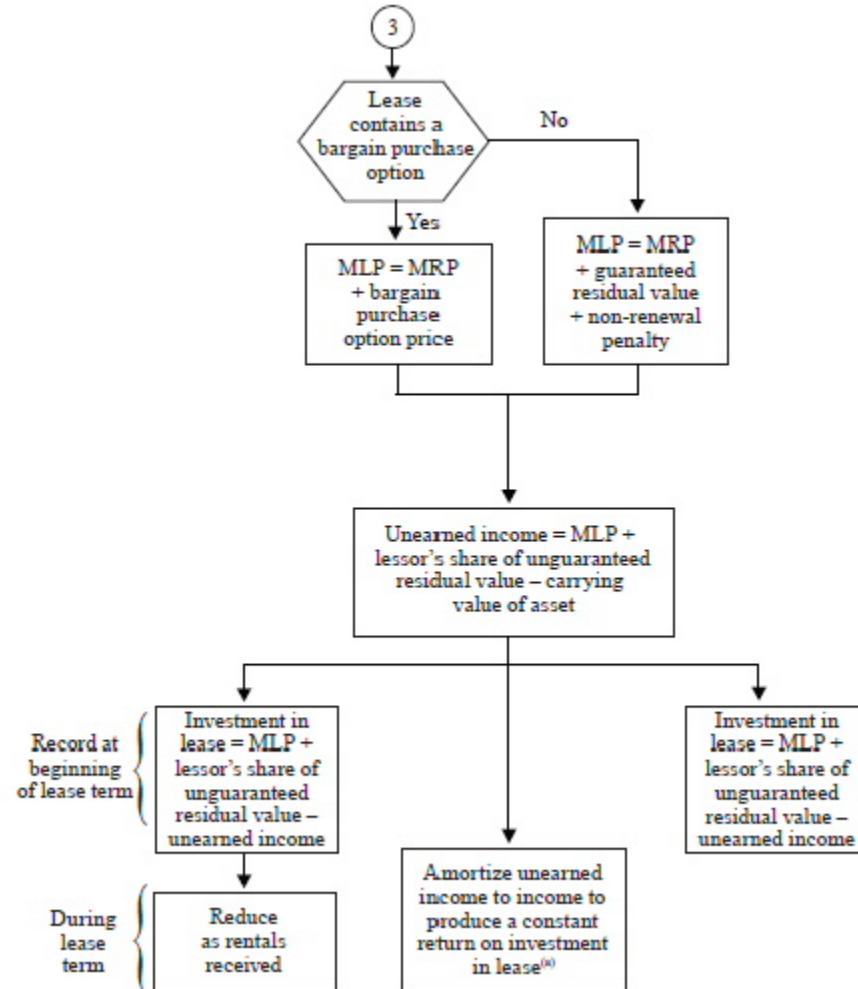
P.V. = Present value

(a) Investment in lease for purposes of income recognition:

- (i) when income tax factors taken into consideration for accounting purposes = MLP + lessor's share of unguaranteed residual value – unearned income – future income taxes – investment tax credit; or

- (ii) when income tax factors not taken into consideration for accounting purposes = MLP + lessor's share of unguaranteed residual value – unearned income.

Decision Tree 5 — Accounting for a direct financing lease



MLP = Minimum lease payments

MRP = Minimum rental payments called for over the lease term

- (a) Investment in lease for purposes of income recognition:

- (i) when income tax factors taken into consideration for accounting purposes = MLP + lessor's share of unguaranteed residual value – unearned income – future income taxes – investment tax credit; or
 - (ii) when income tax factors not taken into consideration for accounting purposes = MLP + lessor's share of unguaranteed residual value – unearned income.
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