Substance over form: The accounting definitions, classification, and treatment of leases under HKAS 17

(Relevant to AAT Examination Paper 7 – Financial Accounting)

Dr. Olivia Leung, The University of Hong Kong
Dr. Annie Mok Yuet-ngo, City University of Hong Kong

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(In the conference room)

Mary *(the operations director)*:
We are in urgent need of a new machine (Machine X) but we cannot afford paying a substantial amount of cash right now to buy it. John, can you think of a solution?

John *(the finance manager)*:
No worries, Mary! We have just signed a non-cancellable 4-year lease with ABC Machinery allowing us to use Machine X with an annual lease payment of $100,000, payable at the end of each year beginning from 31 December 2015. The lease will commence tomorrow on 1 January 2015. My research shows that Machine X has a useful life of 4 years and its fair value is $335,000. The interest rate implicit in the lease is 8% per annum; therefore, the present value of the lease's minimum lease payment is $331,213 on the lease inception date. In fact, ABC Machinery is very happy to lease Machine X to us because no other lessee would be able to use Machine X without any major modifications due to its specialized nature. Although the lease does not transfer the ownership of Machine X to us, nor does it provide us with a purchase option by the end of the lease term, I believe that it is still a good deal for us.

Mary:
Great! We don't need to pay much right now and we will have a new machine to fulfil our customer orders! Well done, John! Hey Peter, how would this lease arrangement affect our performance on the financial statements? After all, our bonus is tied to financial performance…

(Peter, the accounting manager, gets a copy of the lease agreement, studies it very carefully, and recalls the Hong Kong Accounting Standard (HKAS) 17….)

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HKAS 17 defines a lease as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

There are basically two classes of leases: finance leases and operating leases. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in returns because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or the realisation of a residual value.

Whether a lease is a finance lease or an operating lease also depends on the substance of the transaction rather than the form of the contract. For example, the situations that would normally lead to a lease being classified as a finance lease are:

(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; and

(e) the leased assets are of such a specialized nature that only the lessee can use them without major modifications.

Also, there are indicators of situations that could also lead to a lease being classified as a finance lease:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Under a finance lease, at the commencement of the lease term, lessees shall recognize finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.

Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

A finance lease also gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term and its useful life.

Under an operating lease, lease payments shall be recognized as an expense on a straight-line basis over the lease term.

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(In the conference room)

Peter:
According to the lease terms with ABC Machinery, the lease should be classified as a finance lease because:

- the lease term is 100% of Machine X's useful life;
- 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 ($331,213/$335,000 = 99%)
- Machine X is a specialized machine such that only we could use it without major modifications; and
- the lease is not cancellable without the permission of ABC Machinery.

Therefore, we will report the lease as an asset and liability on the lease's commencement date. Subsequently, at each accounting year-end over the lease term, we will report the annual lease payment along with annual finance and depreciation charges. Let me illustrate by showing you the following accounting entries for the lease in 2015 (with a lease payment table after that):

<u>1 January 2015: The commencement date of the lease</u>

Leased Machinery	$331,213	
Lease Liability		$331,213

To recognise the leased machine as asset and liability.

<u>31 December 2015: The first year-end</u>

Lease Liability	$73,503	
Finance Charges ($331,213 × 8%)	$26,497	
Cash		$100,000

To record the first lease payment of $100,000 being apportioned between finance charges and reduction of outstanding liability.

Depreciation Expense ($331,213/4 years)	$82,803	
Accumulated Depreciation – Leased Machinery		$82,803

To record the depreciation expense of the leased machine for the year ended 31 December 2015.

	Beginning Balance $	Interest at 8% $	Payment $	Ending Balance $
2015	331,213	26,497	100,000	257,710
2016	257,710	20,617	100,000	178,327
2017	178,327	14,266	100,000	92,593
2018	92,593	7,407	100,000	0