

Lessee Ltd.- lease case

[Economics](#), [Money](#)



| Lessee Ltd. - Lease Case| | | | | 1. Was the junior accountant's analysis correct? Why or why not? No, the junior accountant's analysis is not correct in classifying the lease as an operating lease in accordance with IFRS.

Whether or not a lease is classified as a finance or an operating lease depends on if all of the benefits as well as risks of ownership have been shifted from the lessor to the lessee.

According to IAS 17-10(d), a lease must be classified as a finance if either " the lease term is for the major portion of the asset's economic life" or " at the inception of the lease the present value of the minimum payment amounts to at least substantially all of the fair value of the lease asset. "

With regards to this case, the term of the lease is equal to 75% of the equipment's useful life. Also, the present value of the annual payments would equal \$263, 716 with the fair value of asset only being \$265, 000, which makes the present value of the minimum lease payment 99. % of the fair value of the leased asset. With these criteria being met it satisfies the requirements of IAS 17 and would therefore be classified as a finance lease

2. Was the senior accountant's analysis correct? Why or why not? The senior accountant's analysis is correct according to IAS 17. The way the senior accountant lays out his thought process in a step-by-step process creates a nice " checklist" to compare to the IAS.

Beginning with step one, the senior accountant classifies the lease as a finance lease on the terms that the life of the contract encompasses the majority of the equipment's useful life. According to IAS 17. 10, the senior accountant is correct. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form.

Situations that would normally lead to a lease being classified as a finance lease include the following: [IAS 17. 0] * the lease transfers ownership of the asset to the lessee by the end of the lease term * the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised * the lease term is for the major part of the economic life of the asset, even if title is not transferred * 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 * the lease assets are of a specialized nature such that only the lessee can use them without major modifications being made

In his second step, the senior accountant uses the wrong interest rate. He states, " Since the lessee's incremental borrowing rate is greater than the lessor's implicit rate in the lease, compute the present value of the minimum lease payments using the 11 percent rate. "

This is wrong because IFRS does not permit the lessee to use the incremental rate if the implicit rate is known. He should have used 10% for his calculations. At commencement of the lease term, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease, if practicable, or else at the entity's incremental borrowing rate) [IAS 17. 20] * $PV \text{ of the minimum lease payments} = \$100,000 \times 2.4896 + \$20,000 \times 0.7513 = \$263,716$

Lastly, the senior accountant uses the wrong number from step 2 and therefore is incorrect in determining the amortization tables. Table 1 below shows the

corrected table. * Finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability (the finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability) [IAS 17. 25] * The depreciation policy for assets held under finance leases should be consistent with that for owned assets.

If there is no reasonable certainty that the lessee will obtain ownership at the end of the lease - the asset should be depreciated over the shorter of the lease term or the life of the asset [IAS 17. 27] 3. How would the answer differ under U. S. GAPP? Under U. S. GAAP many things in the Senior Accountant's computations would change. First you would allocate the payments based on the 10 percent implicit rate from the lessor not the 11 percent incremental borrowing rate from the lessee. This would change the total Lease Obligation to \$263, 716. Below is the new table allocating payments between interest and lease obligation. Table [1]

Year	Cash pmt	Interest expense (10%)	Reduction in Lease Obligation	Balance of Lease Obligation
0				\$263, 716
1	\$100, 000	\$26, 372	\$75, 131	\$190, 088
2	\$100, 000	\$19, 009	\$80, 991	\$109, 097
3	\$100, 000	\$10, 910	\$89, 090	\$20, 007

The balance is the residual value at the end of the lease (\$20, 007? \$20, 000). The journal entry to record the lease obligation would have to change based on the correct percentage. Leased Equipment under Capital Lease \$263, 716 Lease payable \$263, 716 The correct journal entry to record Year 1 payment would be: Rent Expense \$2, 000 Interest Expense \$26, 372 Lease payable \$73, 628 Cash \$102, 000 There would not be any depreciation recorded on this leased equipment due to the title not transferring or a bargain purchase option.