

New Zealand Society of Accountants

STATEMENT OF STANDARD
ACCOUNTING PRACTICE NO. 18

Revised 1990

ACCOUNTING FOR LEASES AND HIRE PURCHASE CONTRACTS

Issued by the Council, New Zealand Society of Accountants

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*This Statement should be read in the context of
the Explanatory Foreword to Statements of Standard Accounting Practice.*

1 INTRODUCTION

- 1.1 This Statement deals with accounting for leases and hire purchase contracts.
- 1.2 This Statement does not deal with the following specialised types of leases:
 - (a) Lease agreements to explore for or to extract natural resources such as oil, gas, timber, metals and other minerals.
 - (b) Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

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2 APPLICATION

- 2.1 The Standard in this Statement applies to all external financial statements.
- 2.2 This Statement of Standard Accounting Practice becomes operative for financial statements covering periods beginning on or after 1 April 1986. Transitional arrangements for lessees are covered in paragraph 4.40.

3 DEFINITIONS

- 3.1 *Lease*: an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time.
- 3.2 *Finance lease*: a lease that transfers substantially all the risks and rewards incident to ownership of an asset to the lessee. Title may or may not eventually be transferred. This definition of a finance lease includes contracts for the hire of assets which contain a provision transferring title to the asset upon the fulfilment of agreed conditions.
- 3.3 *Operating lease*: a lease other than a finance lease.
- 3.4 *Non-cancellable lease*: a lease that may be cancelled only —
- upon the occurrence of some remote contingency; or
 - with the permission of the lessor; or
 - if the lessee enters into a new lease for the same or any equivalent asset with the same lessor; or
 - upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.
- 3.5 *Inception of the lease*: the earlier of the date of the lease agreement or of commitment by the parties to the principal provisions of the lease.
- 3.6 *Lease term*: the non-cancellable period for which the lessee has contracted to lease the asset, together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when, at the inception of the lease, it is reasonably certain that the lessee will exercise the option.
- 3.7 *Minimum lease payments*: the payments that the lessee can be required to make over the lease term (excluding insurance, maintenance and similar costs incurred by the lessor and rechargeable to the lessee) together with any residual value guaranteed by or on behalf of the lessee. The lessee may have the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, such that at the inception of the lease it is reasonably certain that the option will be exercised. In this circumstance the minimum lease payments comprise the minimum rentals payable over the lease term plus the payment required to exercise this purchase option.

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3.8 *Fair value*: the amount for which an asset could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm's length transaction.

3.9 *Useful life* is either —

- (a) the period over which a depreciable asset is expected to be used; or
- (b) the number of production or similar units expected to be obtained from the asset.

3.10 *Guaranteed residual value*: the value of the leased asset guaranteed to the lessor on expiry of the lease term.

3.11 *Unguaranteed residual value*: that portion of the value of the leased asset (estimated at the inception of the lease), the realisation of which by the lessor, at the expiry of the lease term, is not assured, or is guaranteed only by a party related to the lessor.

3.12 *Gross investment in the lease*: the aggregate of the remaining minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

3.13 *Unearned finance income*: the difference between the lessor's gross investment in the lease and its present value.

3.14 *Net investment in the lease*: the gross investment in the lease less unearned finance income.

3.15 *Net cash investment*: the balance of the cash outflows and inflows in respect of the lease excluding flows relating to insurance, maintenance and similar costs incurred by the lessor and rechargeable to the lessee. The cash outflows include payments made to acquire the asset, interest and principal on third party financing and tax payments relative to the lease. Inflows include rental receipts, receipts from residual values, and any other receipts arising from the lease.

3.16 *Interest rate implicit in the lease*: the discount rate that, at the inception of the lease, causes the aggregate present value of —

- (a) the minimum lease payments, from the standpoint of the lessor, and
- (b) the unguaranteed residual value

to be equal to the fair value of the leased asset.

3.17 *Lessee's incremental borrowing rate of interest*: the rate of interest the lessee would incur to borrow the funds necessary to purchase the asset over a similar term and with a similar security.

3.18 *Contingent rental*: a rental that is not fixed in amount but is based on a factor other than just the passage of time (e.g. percentage of sales, amount of usage, price indices, market rates of interest).

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4 DISCUSSION

Classification of Leases

4.1 The classification of leases adopted in this Statement is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's useful life and of gain from appreciation in value or realisation of a residual value.

4.2 Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. Normally the two parties will classify the lease in the same way. Nevertheless, the application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by lessor and lessee.

4.3 Whether a lease is a finance lease or not depends on the substance of the transaction rather than the form of the contract. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Such a lease is normally non-cancellable and secures for the lessor the recovery of his or her capital outlay plus a return for the funds invested. A lease is classified as an operating lease if substantially all the risks and rewards incident to ownership are not transferred.

4.4 A lease would normally be classified as a finance lease where —

- (a) the lease is non-cancellable; and
- (b) collectibility of the minimum lease payments is reasonably predictable; and
- (c) (i) the lease transfers ownership of the asset to the lessee by the end of the lease term; or
 - (ii) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable and that, at the inception of the lease, it is reasonably certain that the option will be exercised; or
 - (iii) the lease term is for a major portion (normally 75 percent) of the useful life of the asset. Title may or may not eventually be transferred; or
 - (iv) the present value, at the inception of the lease, of the minimum lease payments is not less than substantially all (normally 90 percent) of the fair value of the leased asset. Title may or may not eventually be transferred; and
- (d) in the case of the lessor the amount of unreimbursable costs yet to be incurred by the lessor under the lease can be ascertained with reasonable certainty.

The Accounting Treatment of Leases in the Financial Statements of Lessees

4.5 Transactions and other events ought to be accounted for and presented in accordance with their substance and financial reality and not merely with legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for substantially all of its useful life in return for entering into an obligation to pay for that right an amount approximating the fair value of the asset and the related finance charge.

4.6 If such lease transactions are not reflected in the lessee's balance sheet, both the available economic resources and the level of obligations are understated. It is therefore appropriate that a finance lease incurred be recorded in the lessee's balance sheet both as an asset and as an obligation to pay future rentals.

4.7 Hire purchase contracts which are of a financing nature (e.g. conditional purchase agreements) should be accounted for on a similar basis to finance leases.

Finance Leases — Determination of the Amounts of Leased Assets and the Related Liabilities

4.8 The rights and obligations arising from a finance lease are recorded at the beginning of the lease term at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. At the inception of the lease, the asset and the liability for the future rentals are reported in the balance sheet at the same amounts.

4.9 In calculating the present value of the minimum lease payments the discount factor is the interest rate implicit in the lease, if it is practicable to determine; if not, the lessee's incremental borrowing rate is used.

4.10 The depreciation policy for leased assets should be consistent with that for depreciable assets which are owned, and the depreciation charged should be calculated on the basis set out in Statement of Standard Accounting Practice 3 (1984) *Accounting for Depreciation*.

4.11 The difference between the total minimum lease payments over the lease term and the initial recorded net liability represents the finance charge. This charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability during each period. This would normally require the use of the actuarial method. However, where the application of the Rule of 78 would produce a close approximation thereto, use of that method is an acceptable alternative.

4.12 A finance lease gives rise to a depreciation charge and a finance charge for each accounting period. The sum of these amounts is not normally the same as the rentals payable for the period and it is therefore inappropriate simply to charge the

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rentals payable to income. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

Operating Leases

4.13 For operating leases, rental expense (excluding costs for services such as insurance and maintenance) should be recognised on a systematic basis that is representative of the time pattern of the user's benefits, even if the payments are not on that basis.

The Accounting Treatment of Leases in the Financial Statements of Lessors

Finance Leases

4.14 Under a finance lease substantially all the risks and rewards incident to ownership are transferred by the lessor, and thus the lease rentals receivable should be treated by the lessor as repayments of principal and finance income to reimburse and reward the lessor.

4.15 A lessor should aim to allocate finance income over the lease term on a systematic and rational basis. This income allocation is usually based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease. Lease rentals relating to the accounting period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

4.16 At the inception of the lease the lessor, in spreading income on a systematic basis, may recognise uncertainties relating for example to the collectibility of lease rentals. The longer the term of the lease the greater the risks involved and the consideration of prudence may require modification of the pattern of income recognition to reflect the circumstances.

4.17 Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease should be reviewed regularly. If there has been a permanent reduction in the estimated unguaranteed residual value the income allocation over the lease term should be revised and any reduction in respect of amounts already recognised charged to income.

4.18 Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and should be either expensed immediately or allocated against this income over the lease term.

4.19 Certain finance lease transactions are structured in such a way that they involve at least three parties, the lessee, the lessor and one or more long-term lenders who provide part of the acquisition finance for the leased asset usually without any general recourse to the lessor. These lease transactions are sometimes known as leveraged leases. In such cases, the lessor records his/her investment in the lease net of the non-recourse debt and of the related finance costs to the third-

party long term lender and recognises finance income on the basis of his/her net cash investment outstanding in respect of the finance lease.

4.20 Since different results can flow from the use of net investment and the use of net cash investment for allocation of income, the method used needs to be applied consistently to leases of the same financial character and disclosed.

Finance Leasing by Manufacturers or Dealers

4.21 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. The granting of a finance lease by a manufacturer or dealer gives rise to two types of income —

- (a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and
- (b) the finance income over the lease term.

4.22 The sales revenue recorded at the inception of a finance lease by a manufacturer or dealer lessor is the fair value of the asset, or, if lower, the sum of the present values of the minimum lease payments and the estimated unguaranteed residual value accruing to the lessor, computed at a commercial rate of interest. The cost of sale recognised at the inception of the lease is the cost, or carrying amount if different, of the leased asset. The difference between the sales revenue and the cost of sale is the selling profit or loss, which is recognised in accordance with the policy normally followed by the enterprise for outright sales.

4.23 Lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of the sale in which case the selling profit should be restricted to that which would apply if a commercial rate of interest were charged.

4.24 Initial direct costs are usually charged to income at the inception of the lease because they are mainly related to earning the selling profit.

Operating Leases

4.25 Under an operating lease, the risks and rewards incident to ownership of an asset remain with the lessor. Therefore, the asset should be treated by the lessor as a depreciable asset and rentals receivable should be included in income over the lease term. A manufacturer or dealer lessor should not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

4.26 Costs, including depreciation, incurred in earning the rental income should be charged to income. Rental income (excluding receipts for services provided such as insurance and maintenance) should normally be recognised on a straight line basis over the lease term, even if the receipts are not on such a basis, unless

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another systematic basis is more representative of the time pattern of the earnings process contained in the lease.

4.27 A leased asset should be depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets, the depreciable amount of the asset being allocated on a systematic basis to each accounting period during its useful life.

Land and Buildings

4.28 Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite useful life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee does not receive substantially all of the risks and rewards incident to ownership. Such a lease should therefore be properly classified as an operating lease. A premium paid for such a leasehold represents pre-paid rental charges which should be amortised over the lease term.

4.29 Many buildings that are leased have a useful life that is expected to extend well beyond the end of the lease term. Moreover, long-term leases for buildings often contain provisions whereby rents are regularly adjusted to market rates. If title is not expected to pass or if rents are regularly adjusted to market rates, the lessor retains a significant part of the risks and rewards incident to ownership and such leases should therefore normally be classified as operating leases.

Sale and Leaseback

4.30 A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The rentals and the sale price are usually interdependent as they are negotiated as a package and need not represent fair values. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

4.31 If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. For this reason it is not appropriate to regard an excess of sale proceeds over the carrying amount as a realised profit. Such excess should be deferred and amortised over the lease term.

4.32 If the leaseback is an operating lease, and the rentals and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss should be recognised.

4.33 When the leaseback is an operating lease and the sale price is below fair value any profit or loss should be recognised immediately, except that if the loss is compensated by future rentals at below market price the loss may be deferred and amortised over the period for which the asset is expected to be used. If the sale price is above fair market value and the profit is compensated by future rentals in

excess of market price, the excess should be deferred and amortised over the period for which the asset is expected to be used.

4.34 For operating leases, if the fair value at the time of the transaction is less than the carrying amount, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Disclosure

Disclosures in the Financial Statements of Lessees

4.35 It is appropriate that the amount of assets used by the lessee that are the subject of finance leases be separately identified in the financial statements together with the related accumulated depreciation. Separate disclosure of leased assets should be made by each major class of assets.

4.36 The aggregate amount of the related liabilities should be shown either as the total of the minimum lease payments, with future finance charges being separately deducted, or as the present value of the liabilities, disclosing in summary form the interest rates used as the discounting factors. It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets.

4.37 Certain other disclosures relevant to both finance and operating leases are also appropriate. Examples of these are —

- (a) the nature of any renewal options, purchase options or escalation clauses;
- (b) financial restrictions imposed by the lease agreement such as limitations on additional borrowing or further leasing;
- (c) the nature of any contingent rentals such as those based on usage or sales;
- (d) the nature of any contingent liability in respect of costs expected at the end of the lease term;
- (e) the amount of interest on finance lease contracts charged against income in the year.

Disclosures in the Financial Statements of Lessors

4.38 The lessor's gross investment in finance leases and the amount of unearned finance income should be disclosed.

4.39 Assets held for use in operating leases should be included as fixed assets in the balance sheet. The amount of these leased assets presented by each major class of asset should be disclosed together with any related accumulated depreciation or amortisation.

Transitional Arrangements for Lessees

4.40 The application of the Standard in this Statement is encouraged for all finance leases in existence as at 1 April 1986. It is recognised that practical

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difficulties may preclude immediate adoption. Accordingly transitional arrangements are that:

- (a) the Standard in this Statement applies to all leases entered into on or after 1 April 1986;
- (b) for finance leases in existence at 31 March 1986 the Standard becomes operative for financial statements covering periods beginning on or after 1 April 1988. During the transitional period the following should be shown separately by way of note:
 - (i) total lease payments for the period;
 - (ii) lease commitments at balance date in aggregate classified into —
 - current
 - non current.

In applying the Standard in the Statement for existing leases, regard should be had to paragraph 5.3 of SSAP-7, *Extraordinary Items and Prior Period Adjustments*. Where recognition of the prior period adjustment is impractical the asset and liability may be recorded at the present value of the remaining minimum lease payments.

5 STANDARD ACCOUNTING PRACTICE

Accounting for Leases and Hire Purchase Contracts

The Standard set out in the following paragraphs should be read in the context of the foregoing paragraphs of this Statement and the Explanatory Foreword issued by the Council of the New Zealand Society of Accountants.

Accounting for Leases in the Financial Statements of Lessees

Finance Leases

5.1 A finance lease should be reflected in the balance sheet of a lessee by recording an asset and a liability at amounts equal at the inception of the lease to the fair value of the leased property, or if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the discount factor should be the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

5.2 Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the outstanding balance of the liability for each period. However, where the application of the Rule of 78 would produce a close approximation thereto the use of that method is permitted.

5.3 The depreciation policy for leased assets should be consistent with that for depreciable assets which are owned, and the depreciation charged should be calculated on the basis set out in Statement of Standard Accounting Practice 3 (1984) *Accounting for Depreciation*.

Operating Leases

5.4 The charge against income under an operating lease should be the rental expense for the accounting period, recognised on a systematic basis that is representative of the time pattern of the user's benefit.

Accounting for Leases in the Financial Statements of Lessors

Finance Leases

5.5 Finance leases should be reflected in the balance sheet of a lessor by recording the amount equal to the net investment in the leases as a receivable.

5.6 The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either the lessor's net investment outstanding or the net cash investment outstanding in respect of the finance lease. The method used should be applied consistently to leases of a similar financial character.

5.7 Manufacturer or dealer lessors should include selling profit or loss in income in accordance with the policy normally followed by the enterprise for outright sales. If artificially low rates of interest are quoted, selling profit should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be charged to income at the inception of the lease.

Operating Leases

5.8 Assets held for operating leases should be recorded as fixed assets in the balance sheet of lessors.

5.9 Rental income should be recognised on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earnings process contained in the lease.

5.10 The depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets, and the depreciation charge should be calculated on the basis set out in Statement of Standard Accounting Practice No 3 (1984) *Accounting for Depreciation*.

Accounting for Sale and Leaseback Transactions

5.11 If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be recognised in income in the financial statements of a seller-lessee. The excess should be deferred and amortised over the lease term.

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5.12 If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future rentals at below market price, it may be deferred and amortised in proportion to the rental payments over the period for which the asset is expected to be used. If the sale price is above fair value, and if the profit is compensated by future rentals in excess of market price, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

5.13 For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Disclosures in the Financial Statements of Lessees

5.14 Disclosure should be made of significant financing restrictions, renewal or purchase options, contingent rentals and other contingencies arising from leases, whether they be financing or operating leases.

Finance Leases

5.15 For finance leases, the following should be shown separately in the lessee's financial statements:

- (a) for each major class of asset, the aggregate of the amounts initially capitalised as lease assets, with accumulated depreciation shown as a deduction therefrom;
- (b) the amount of finance charges relating to the lease liabilities included in the determination of the operating result for the accounting period;
- (c) lease liabilities as at balance date, classified into the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than two years;
 - (iii) later than two years and not later than five years; and
 - (iv) later than five years.

Operating Leases

5.16 For operating leases, there should be shown separately in the lessee's financial statements the total amount of rental expense included in the determination of the operating result for the accounting period.

5.17 For non-cancellable operating leases with a lease term of more than one year, the lessee's financial statements should disclose lease commitments in aggregate as at balance date, classified into the following periods:

- (i) not later than one year;
- (ii) later than one year and not later than two years;

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- (iii) later than two years and not later than five years; and
- (iv) later than five years.

Disclosures in the Financial Statements of Lessors

5.18 The gross investment in finance leases should be disclosed in the financial statements together with the related unearned finance income and unguaranteed residual values of leased assets.

5.19 Disclosures should be made of the basis used for allocating income so as to produce a constant periodic rate of return, indicating whether the return relates to the net investment outstanding or the net cash investment outstanding in the lease. If more than one basis is used, the bases should be disclosed.

5.20 Assets held for use in operating leases should be included as fixed assets in the balance sheet. The amount of these leased assets presented by each major class of asset, should be disclosed together with any related accumulated depreciation or amortisation.

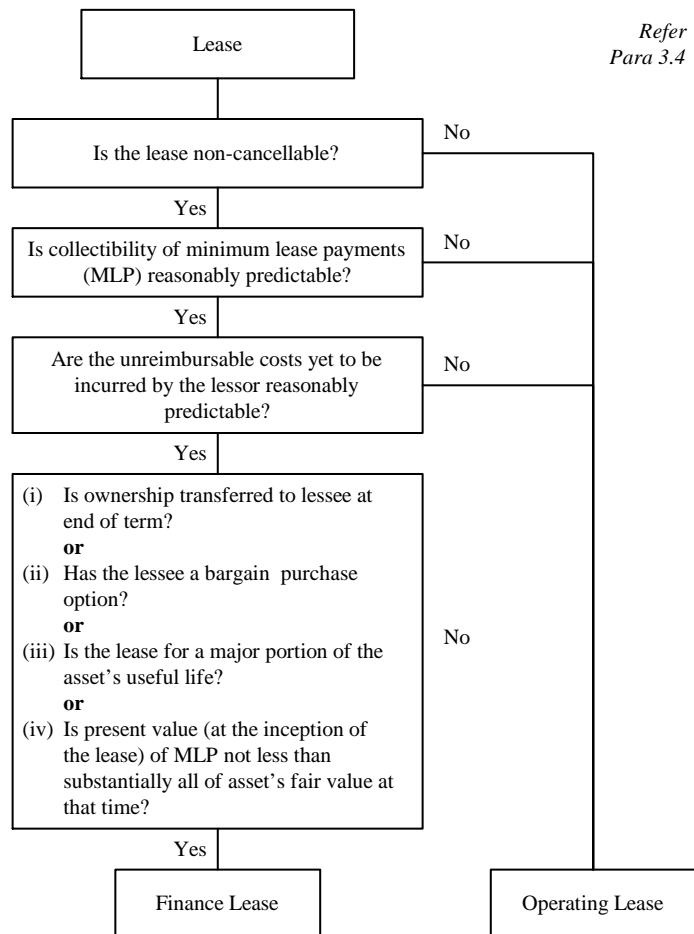
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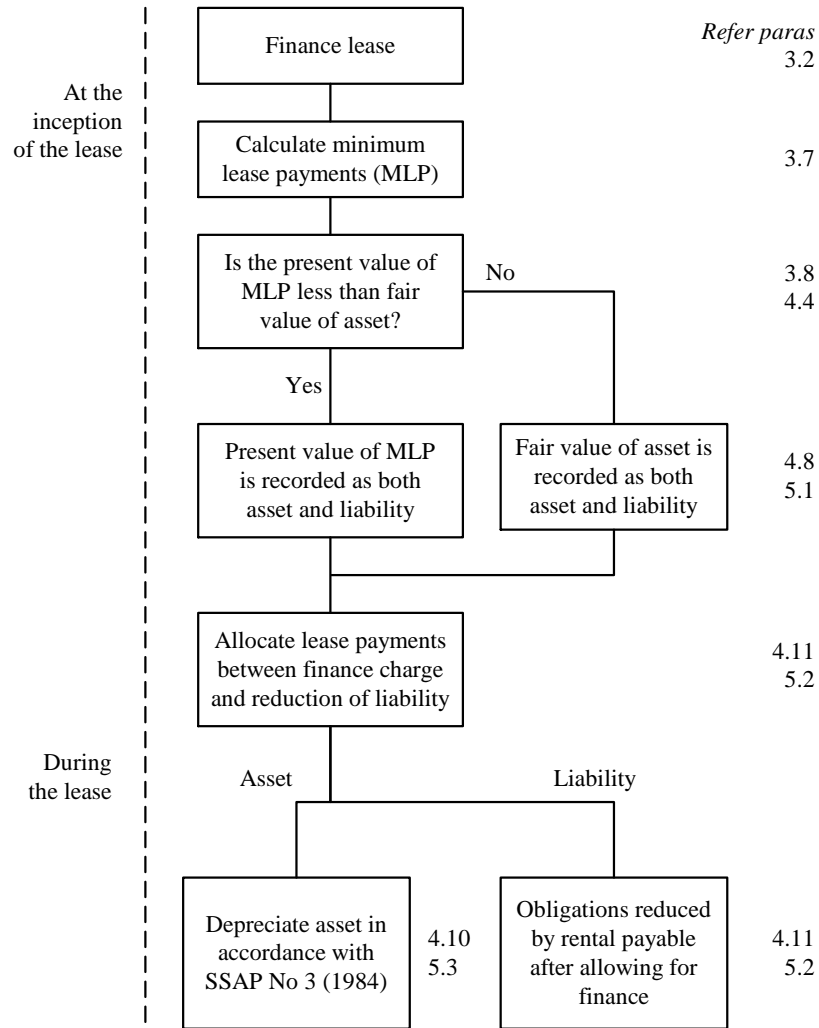
Note: This appendix is included for illustrative purposes only and does not form part of the Standard in this Statement.

Classification of a Lease

A finance lease is defined in paragraph 3.2 as a lease that transfers substantially all the risks and rewards incident to ownership of an asset to the lessee. The objective of the following chart is to assist in classifying a lease either as a finance lease (as explained in paragraphs 4.3 and 4.4) or as an operating lease. It is stated in paragraph 4.4 that the criteria are indications of where a lease would normally be classified as a finance lease.



Accounting for a Finance Lease by a Lessee



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Accounting for a Finance Lease by a Lessor

