

## CLASSIFICATION OF LEASES BY LESSEE: Capital Or Operating

When substantially all the risks and benefits of ownership are transferred from the lessor to the lessee, the lease should be classified and accounted for as a capital lease under ASPE. This is so if one or more of the following criteria are met on the date of the lease agreement:

1. There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the term. A **bargain purchase option** is assumed to be exercised by the lessee.
2. The term of the lease is long enough for the lessee to recover most of the asset benefits. The term is considered long enough if it equals **75% or more of the estimated economic life** of the leased property.
3. The lease allows the lessor to recover substantially all of its investment in the leased property and to earn a return on the investment. This is evident if the present value of the minimum lease payments (excluding executory costs) equals or exceeds **90% of the fair value** of the leased property.

All leases that **fail to meet at least one of the three criteria** above are classified and accounted for by the lessee as **operating leases**.

Similarly under IFRS, a lease that transfers substantially all the benefits and risks of property ownership should be capitalized.

1. There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. If there is a bargain purchase option in the lease, it is assumed that the lessee will exercise it and obtain ownership of the asset.
2. The lease term is long enough that the lessee will receive substantially all of the economic benefits that are expected to be derived from using the leased property over its life.
3. The lease allows the lessor to recover substantially all of its investment in the leased property and to earn a return on the investment. Evidence of this is provided if the present value of the minimum lease payments is close to the fair value of the leased asset.
4. The leased assets are so specialized that, without major modification, they are of use only to the lessee.

**Any one or a combination** of the above conditions would normally indicate that the transfer of benefits and risks has occurred and the lease be classified as a **capital lease**.

## CRITERIA TESTS

Transfer Of Ownership Test

Economic Life Test

Recovery Of Investment Test

## OTHER FACTORS

### 1. Executory Costs

If Paid By Lessor, Amount Must Be Deducted From The Minimum Lease Payments

### 2. Discount Rate

Rate To Be Used By Lessee In Determining Minimum Lease Payments.

☞ Implicit Rate In The Lease: Lessor's Internal rate Where The PV of Minimum Lease Payments Equals The FMV Of The Leased Asset.

☞ Lessee's Incremental Borrowing Rate At The Beginning Of The Lease.

**PE GAAP: Lower Of The Two rates**

**IFRS: The Implicit Rate Whenever Reasonably Determinable; Otherwise The Incremental Rate.**

### 3. Residual Value - Guaranteed vs Unguaranteed

When RV Is Determined, Lessor, With A Lower Amount For Future Recovery, Will Reduce The PV Of The Estimated RV From the FMV Of The Leased Asset.

When RV Is Guaranteed, Lessor With A Lower Risk Of Future Recovery, May Reduce The Rate Of Return Charged To The Lessee.

## CLASSIFICATION OF LEASES BY LESSOR: Capital Or Operating

### **GROUP I**

When substantially all the risks and benefits of ownership are transferred from the lessor to the lessee, the lease should be classified and accounted for as a capital lease under ASPE. This is so if one or more of the following criteria are met on the date of the lease agreement:

1. There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the term. A **bargain purchase option** is assumed to be exercised by the lessee.
2. The term of the lease is long enough for the lessee to recover most of the asset benefits. The term is considered long enough if it equals **75% or more of the estimated economic life** of the leased property.
3. The lease allows the lessor to recover substantially all of its investment in the leased property and to earn a return on the investment. This is evident if the present value of the minimum lease payments (excluding executory costs) equals or **exceeds 90% of the fair value** of the leased property.

### **GROUP II**

#### **ADDITIONAL OTHER CRITERIA**

1. The credit risk associated with the lease is normal when compared to the risk of collection of similar receivables.
2. The amounts of any non-reimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated

All leases that **meet at least one of the three criteria** in Group I above and both in Group II are classified and accounted for by the lessor as either **Direct Financing or Sales Type leases**.

## GROUP I

Similarly under IFRS, a lease that transfers substantially all the benefits and risks of property ownership should be capitalized.

1. There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. If there is a bargain purchase option in the lease, it is assumed that the lessee will exercise it and obtain ownership of the asset.
2. The lease term is long enough that the lessee will receive substantially all of the economic benefits that are expected to be derived from using the leased property over its life.

3. The lease allows the lessor to recover substantially all of its investment in the leased property and to earn a return on the investment. Evidence of this is provided if the present value of the minimum lease payments is close to the fair value of the leased asset.
4. The leased assets are so specialized that, without major modification, they are of use only to the lessee.

**Any one or a combination** of the above conditions would normally indicate that the transfer of benefits and risks has occurred and the lease be classified by the lessor as either **a Other Finance or Manufacturer/Dealer Type lease**.

## OTHER FACTORS

### Initial Direct Costs Of Lessor

Costs incurred by the lessor associated with negotiating, consummating, and processing the lease.

**Operating leases:** Defer such costs and allocate them over the lease term in proportion to the recognition of rental income.

**Sales-type (Manufacturer/Dealer) leases:** Expensed in the period when incurred when the profit on sale is recognised.

**Direct financing (Other Finance) leases:** Allocated over the term of the lease.