

Substance over form and leases

There has long been a principle of financial reporting that, in deciding the appropriate method to record transactions, economic substance should take precedence over legal form. This is the basis of FRS 5 *Reporting the Substance of Transactions*, issued in 1994, to deal with the many complex transactions that had developed as a consequence of the ingenuity of the financial experts. We discuss FRS 5 in the first part of this chapter.

A very important example of the substance over form principle is to be found in the accounting treatment of leases. Indeed, so important is the example that the ASB produced a standard on the subject, SSAP 21 *Accounting for Leases and Hire Purchase Contracts* in 1984, some ten years before FRS 5 saw the light of day. SSAP 21 distinguishes between two different categories of lease – *finance*¹ and *operating* leases respectively, and requires very different accounting treatments of each. A lessee is required to capitalise a finance lease, that is to recognise both a fixed asset and a liability, charging depreciation of the asset and an interest or finance charge in respect of the liability in its profit and loss account. A lessee must not capitalise an operating lease, rather the rentals payable should be charged to the profit and loss account in accordance with the accruals concept. The accounting treatment of leases by the lessor mirrors the treatment by the lessee.

In the second part of this chapter, we explore the issues involved in the treatment of leases and explain the provisions of SSAP 21 in some detail. We illustrate the accounting treatment of finance and operating leases by both lessees and lessors. The provisions of the international standard IAS 17 are similar to those of SSAP 21 although there are differences, especially in the treatment of the income from finance leases by lessors.

In recent years, the view has emerged, both in the UK and overseas, that it is unrealistic to attempt to make a distinction between the two categories of leases and that in conceptual terms a strong case could be made for requiring the capitalisation of all non-cancellable leases. We explain this view, which is promulgated in two Discussion Papers issued by the G4+1 group, a view that now has strong support from both the ASB and the IASB, although it has yet to emerge in the form of an exposure draft.

In this chapter, we will discuss the following publications:

- FRS 5 *Reporting the Substance of Transactions* (1994, amended 1998)
- SSAP 21 *Accounting for Leases and Hire Purchase Contracts* (1984, amended 1997)
- IAS 17 *Leases* (revised 1997)
- G4+1 Discussion Paper *Accounting for Leases: A New Approach*, published by the FASB (1996)
- G4+1 Position Paper *Leases: Implementation of a New Approach*, also published as a Discussion Paper by the ASB (1999)

¹ This is the term used by the ASB and IASB. In the USA and Canada, finance leases are called capital leases or sales type leases.

Introduction

The vast majority of transactions of the vast majority of companies are simple and straightforward. A fixed asset or an item of stock is purchased for cash or on credit and the impact on the company's assets and liabilities can be easily assessed. But occasionally a company will enter a complex set of transactions that involve a series of different events that, if viewed in isolation, might give a misleading picture.

Let us suppose X Limited 'sells' some land to Y Bank for £5m with an option to reacquire it for, say, £5.4m in six months' time.

Is it a genuine sale or is it a device to borrow money, 'off the balance sheet', for six months? And, if it is the latter, would the financial statements show a more realistic picture if the asset were not treated as a sale, but retained as an asset with the corresponding recognition of the obligation to 'repay' the bank?

The task is to determine the substance of the transaction. The doctrine of 'substance over form' is found in many attempts to construct a conceptual framework of accounting. Many interpretations have been made of the phrase but it is perhaps most readily understood as the belief that financial statements should, when there is conflict, be based on economic (or commercial) reality rather than legal form.²

Reflecting the substance of transactions

FRS 5 Reporting the Substance of Transactions

FRS 5 requires that the reporting entity's financial statements should report on the substance of the transaction into which it has entered (Para. 14).

FRS 5, as are many of the transactions to which it relates, is complex but there is a simple governing principle which is that, when determining the nature of a transaction, one needs to decide whether, as a result of the transaction, the reporting entity has created new assets or liabilities or whether it has changed any of its existing assets or liabilities (Para. 16). The standard hence adopts a strictly 'balance sheet' approach: identify the assets and liabilities and let the profit and loss account entry emerge.

In order to determine 'substance' FRS 5 emphasises the need to identify all aspects and implications of a complex transaction and points out that some aspects may be uncertain or contingent and that greater weight needs to be given to those aspects which are likely to have a commercial effect in practice. The standard suggests that the accountant needs to consider the expectations and motivation of all parties to the transaction and points out that, whatever is the substance of the transaction, it will normally have a commercial logic for all the parties and hence, if a transaction appears not to make sense, this might indicate 'that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed' (Para. 51). In other words it suggests that if the accountant digs deep enough the reality of the transaction will emerge.

² For a comprehensive discussion on the subject see B.S. Rutherford, *The Doctrine of Substance over Form*, Certified Accountants Publications, London, 1988.

The standard is relevant to those complex transactions whose substance is not readily apparent and whose commercial effect may not be fully reflected by their legal form. Common features of such transactions are:

- 1 the separation of legal title to an item from the ability to enjoy the principal benefits and exposure to the principal risks associated with it;
- 2 the linking of a transaction with one or more others in such a way that its commercial effect cannot be understood without reference to the series as a whole; and
- 3 the inclusion in a transaction of one or more options whose terms make it highly likely that the option or options will be exercised.

Scope of FRS 5

With certain exceptions, which are summarised in Table 9.1, the standard covers all transactions of all entities whose financial statements are intended to give a true and fair view of its financial position and profit or loss for a period. The standard is, for the most part, couched in pretty general terms and hence, when a transaction which would otherwise fall within the scope of the standard is also covered by another FRS, or a SSAP or specific statutory requirement, the standard or statute that contains the more specific provision or provisions should be applied (Para. 13).

Table 9.1 Transactions outside the scope of FRS 5 (unless part of a transaction that falls within its scope)

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- 1 Forward contracts and futures
 - 2 Foreign exchange and interest rate swaps
 - 3 Contracts where a net amount will be paid or received based on the movement in a price or an index ('contracts for differences')
 - 4 Expenditure commitments and orders placed, until the earlier of delivery or payment
 - 5 Employment contracts.
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The structure of FRS 5

The standard deals with the following main issues:

- (a) the identification of assets and liabilities and tests for whether the asset or liability should be recognised in the balance sheet;
- (b) transactions in previously recognised assets;
- (c) the treatment of options;
- (d) assets which are separately financed and, in particular, the circumstances where 'linked presentation' should be used (linked presentation means that, on the face of the balance sheet, the finance should be deducted from the gross amount of the asset which it finances);
- (e) the, very limited, circumstances when it is permissible to offset assets and liabilities;
- (f) the treatment of 'quasi-subidiaries', when the relationship between the two entities is effectively, but not legally, one between a parent and its subsidiary.

We will examine the provisions of FRS 5 in the above order.

The identification of assets

An asset³ is defined as:

Rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (Para. 2)

While in the context of an asset, control is defined as:

The ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits. (Para. 3)

Although the existence of future benefits is an essential criterion for the identification of an asset, it is not implied that the asset should be valued by reference to those benefits, although the present value of the asset's expected future benefits will provide an upper limit to its carrying value.

All assets carry some risk and the allocation of that risk between the various parties to a transaction will usually be a significant indication of whether the transaction has resulted in the acquisition or disposal of an asset. Risk is the potential variation between the actual and expected benefits associated with the asset and includes the potential for gain as well as exposure to loss. Normally the party that has access to the benefits also has to face the risks, and in practice the question of whether an asset should be identified is often dependent on an assessment of where the risk falls.

Control in this context is related to the means by which an entity ensures that the benefits accrue to itself and not to others and must be distinguished from the day-to-day management of the asset. Although control normally rests on the foundation of legal rights, the existence of such rights is not essential as commercial, or even moral, obligations may be significant factors.

The existence of an asset depends on a past and not a future event. Thus, in straightforward transactions it is easy to draw a distinction between a right to immediate control over future economic benefits and a right to acquire such control in the future. Both rights can be regarded as creating assets, but in the second case the asset is simply the option. The position in linked transactions may be different. An option may be simply a device to ensure that effective control of future benefits will be retained by the party who ceases, temporarily, to be the legal owner. Then the terms of the option may be such that the costs of exercising it are negligible compared to the benefits; in other words it would be commercial madness not to exercise the option. In such a case the accounting treatment (is there an asset and if so what is it?) will have to be decided by reference to the rights and obligations (including those taking effect in the future) that result from the transactions as a whole.

The identification of liabilities

A liability is defined as:

An entity's obligations to transfer economic benefits as a result of past transactions or events. (Para. 4)

Little is said in FRS 5 on the general issue of liabilities but what is said is consistent and does not go beyond our discussion of the subject in Chapter 7.

³ Although FRS 5 considerably predates the *Statement of Principles* there are no differences in substance between the key definitions of assets, liabilities, etc. provided in the two documents. We have examined the definitions of assets and liabilities in Chapters 1, 5 and 7.

Recognition of assets and liabilities

Assets and liabilities, although identified in terms of the above, should only be recognised in the balance sheet if:

- (a) there is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and
- (b) the item can be measured as a monetary amount with sufficient reliability. (Para. 20)

An obvious example of an item which although identified may not be recognised in the balance sheet is a contingent liability.

The above general criteria for recognition are also to be found in Chapter 5 of the ASB's *Statement of Principles*, which we have discussed earlier in this book in Chapters 1, 5 and 7.

Transactions in previously recognised assets

The basic principle is straightforward. If, as a result of a transaction involving a previously recognised asset, there is no significant change in either the reporting entity's access to benefits or exposure to the risks inherent in those benefits, then the asset should continue to be recognised. The asset should cease to be recognised if both the access to benefits and the exposure to risks are transferred to others (Para. 22).

The range of possible outcomes can be well illustrated by the factoring of trading debts. If the terms of the deal are such that, although the legal title to the debts has been transferred, the finance charge that the 'seller' of the debts will have to pay will depend on the speed at which debtors pay or the seller retains responsibility for the whole or part of the bad debts, then the risk has not been transferred and the asset, debtors, should continue to be shown in the balance sheet as the total amount due from debtors. The amount received from the factors in respect of the debts that are still outstanding would be included in liabilities. (There is a possible exception that would arise if the transaction satisfies the condition for linked presentation, see p. 210). On the other hand, if the terms of the agreement are that the finance fee payable will be in no way affected by the future behaviour of the debtors then the whole of the risk has been transferred to the factors and the asset should cease to be recognised.

Special cases of transactions

Three special cases are mentioned in the standard:

- (a) a transfer of only part of the asset;
- (b) a transfer of all the item for only part of its life;
- (c) a transfer of all the item for all its life but where the entity retains some significant rights to benefits or exposure to risks.

It may be helpful to provide some examples of the special cases:

- 1 The holder of a security might sell the right to receive the annual interest but retain the right to receive the principal.
- 2 The seller agrees to repurchase the asset it has sold after its use.
- 3 A company might sell its interest in a subsidiary in circumstances where the ultimate consideration depends in whole or in part on the future performance of the subsidiary.

The main point of the standard is pretty simple. In all cases an asset, albeit a different asset, continues to exist but its description and the amount at which it is included in the balance sheet will change, and it is, of course, possible that the 'new' asset will not pass the recognition tests to which we referred earlier.

Treatment of options

One of the characteristics of complex transactions may be the existence and use of options.⁴ In deciding how to treat them, consideration needs to be given to all aspects of the series of transactions of which the option is part. If, after such consideration, it is decided that there is no genuine commercial possibility that the option will be exercised, the exercise of the option should be ignored whilst, if there is no genuine commercial possibility that the option will fail to be exercised, its future exercise should be assumed (Para. 61).

In assessing whether there is a genuine commercial possibility that an option will be exercised it should be assumed that the parties will act in accordance with their economic interests and that the parties will remain both liquid and solvent, unless it can reasonably be foreseen that either will not be the case. Thus, actions, which the party will take only in the event of a severe deterioration in liquidity or creditworthiness that is not currently foreseen, should not be taken into account.

There will be some circumstances that fall between the two certainties – the exercise or non-exercise of the option. In such a case the asset that would appear in the balance sheet of the entity with the right to acquire would not be the asset itself but the option to acquire the asset. Let us return to our simple example that involved X Limited ‘selling’ some land to a bank for £1m with an option to repurchase. If the price at which the option would be exercised is such that it is virtually certain to be less than the then market price, FRS 5 requires the transaction to be treated as a loan. If, conversely, the option price is virtually certain to be more than the prevailing market price then it would be presumed that the option would not be exercised and the transaction should be treated as a sale. But suppose there exists uncertainty, in that the option price lies within a range in which the market price of the land might reasonably be expected to fluctuate. In that case the asset that X Limited would show would be the option to reacquire the land, and the cost of that asset would be the extra finance costs that the borrower would incur in a transaction that involved an option as against a straightforward borrowing which did not include an option.

Linked presentation

A borrower can finance an item on such terms that the provider of finance has access only to the item financed and not to the entity’s other assets. A well-known example of this is the factoring of debts. In some such arrangements, whilst the provider of finance has only recourse against the specified item, the ‘borrowing’ entity retains rights to the benefits generated by the asset, and can repay the finance from its general resources if it wishes to preserve those rights. In such situations the entity has both an asset and a liability and linked presentation would not be appropriate.

Linked presentation, which as we shall see involves setting off, on the face of the balance sheet, the liability against the asset, is only possible in situations where the finance has to be repaid from the benefits generated by the asset and the borrowing entity has no right to keep the item or to repay the finance from its general resources. The remaining conditions that have to be satisfied are set out in the standard at Para. 27; the essence of these conditions is that the borrower is under no legal, moral or commercial obligation to repay the loan other than from the benefits generated from the asset.

The question to be answered is, ‘What is the nature of the asset which is retained by the borrowing entity and, in particular, what rights and benefits are associated with that asset?’ The issue is best explained by introducing the example used in FRS 5.

⁴ The disclosure requirements relating to options and other derivatives are discussed in Chapter 8.

Suppose that an entity transfers title to a portfolio of high quality debts of 100 in exchange for non-returnable proceeds of 90 plus rights to a further sum whose amount depends on whether the debts are paid. If we assume that the 90 is under no circumstances repayable then there are three ways of presenting the position in the balance sheet:

- (a) Show the asset as 100 and a liability, distinct and separate, of 90. The problem with this form of presentation is that it would not reflect clearly the fact that the 90 liability has no relevance to the remaining assets of the entity and would, in particular, give a misleading view of the security of the entity.
- (b) Set off the two amounts and show 10 as an asset. This may appear to be the most sensible procedure but it is argued that because the eventual return to the entity depends on the behaviour of the whole portfolio of debts which has been factored the risks remaining are the normal risks which could be related to that total portfolio of debt.
- (c) Use what FRS 5 describes as the ‘linked presentation’ method: that is to show on the face of the balance sheet both the gross asset of 100 less possibly a small deduction for the normal provision against doubtful debts, and a deduction of 90. It is claimed that this presentation shows both that the entity retains significant benefits and risks relating to the whole portfolio of debts and that the claims of the provider of the finance are limited solely to the funds generated by the debts.

The art of financial statement preparation is not well served by over-elaboration and the drawing of fine distinctions based on immaterial differences. The ‘linked presentation’ provision smacks of over-elaboration and its application would provide only marginal assistance to the users of financial statements while adding the possibility of confusion. To take the ASB’s own example, what is the asset, 100 or 10? Ignoring bad debts it is 10, the maximum that will be received in the future from the asset; 90 has been received but would in no circumstances have to be repaid, and so it is not a liability. Why suggest that it is? The obvious way of accounting for the transaction is to show the asset at 10 less an appropriate provision against doubtful debts. The fact that the provision is actually based on 100 rather than 10 can be explained in the notes if the fact is material.

However, the conditions that have to be satisfied if linked presentation is to be used are stringent and hence only apply to a small number of entities.

Offset

It is a general requirement of UK company law that assets and liabilities should not be netted off. The only exception is where the right of set-off exists between monetary assets and liabilities, such as, for example, in bank balances and overdrafts with the same party. The provisions of FRS 5 are more stringent and more precise than those found in company law and include the unambiguous statement that ‘assets and liabilities should not be offset’ (Para. 29). However, it goes on to state, in the same paragraph, that ‘debit and credit balances should be aggregated into a single net item where, and only where, they do not constitute separate assets and liabilities’.

The offset should only be made when the balances are fundamentally linked such that the reporting entity would not have to transfer economic benefit arising from the credit balance without being sure that it would receive the benefits reflected by the debit balance.

The conditions under which offset should and must be applied are set out in para. 29 and may be summarised as follows:

- (a) The items to be offset must be determinable monetary amounts denominated either in the same currency or in different but freely convertible currencies.

- (b) The reporting entity has the ability to insist on a net settlement and this ability is assured beyond doubt. This means, for example, that the debit balance matures no later than the credit balance and that the arrangement is such that it would survive the insolvency of the other party.

Disclosure

In the world of complex transactions some assets may differ in some ways from most other assets, and some liabilities, such as limited recourse finance, may differ from the generality of liabilities. A common example of a different form of asset is one that, while it is available for use in the trading activities of the enterprise, may not be available as security for a loan.

The disclosure requirements of FRS 5 are less specific than admonitory, urging that:

Disclosure of a transaction in the financial statements, whether or not it has resulted in assets or liabilities being recognized or ceasing to be recognized, should be sufficient to enable the user of the financial statements to understand its commercial effect. (Para. 30)

Where a transaction has resulted in the recognition of assets or liabilities whose nature differs from that of items usually included under the relevant balance sheet headings, the differences should be explained. (Para. 31)

Quasi-subidiaries

FRS 5 observes that there can be instances where, although the relationship between two companies may not constitute a parent/subsidiary relationship as defined by statute, the dominant company might have as much effective control over the assets of the other as would have been the case had the company been a subsidiary. A simple example is one where the dominant company holds less than 50 per cent of the equity of the other company but has an option to acquire additional shares which would take its holding over 50 per cent.

The standard refers to the controlled company as a quasi-subidiary, which it defines as follows:

A quasi-subidiary of a reporting entity is a company, trust, partnership or other vehicle which, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives rise to benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary. (Para. 7)

The concept of substance over form requires that a company which is in effect a subsidiary should be treated as such and this is supported by s. 227(6) of the Companies Act 1985 as amended by the Companies Act 1989, which specifies that, if in special circumstances compliance with any provisions of the Act with respect to the matters to be included in a company's group accounts or in the notes thereto is inconsistent with the true and fair view requirement, the directors shall depart from that specific provision to the extent necessary to give a true and fair view. FRS 5 points out that the nature of quasi-subidiaries is such that their existence will usually constitute such special circumstances. Thus, they should be included in the consolidated financial statements in the same way as legally defined subsidiary undertakings. If the dominant company does not have any subsidiaries it should provide, in its financial statements, consolidated financial statements of itself and the quasi-subidiary (Para. 35). In addition, the notes to the financial statements should include summaries of the financial statements of the quasi-subidiaries (Para. 38).

The conditions under which subsidiaries are required to be excluded are set out in FRS 2 *Accounting for Subsidiary Undertakings*, but the grounds for exclusion are not applicable to quasi-subidiaries, which, by definition, need to be included in the consolidation if a true

and fair view is to be provided. FRS 5 concludes that the only circumstances under which quasi-subidiaries should be excluded are when they are held only with a view to subsequent sale and have not previously been included in the entity's consolidated financial statements (Para. 36). One set of circumstances is identified in the standard where the accounting treatment of a quasi-subidiary would differ from that of a fully-fledged subsidiary. This occurs when the quasi-subidiary holds either a single item or a single portfolio of similar items that are financed in such a way as to require the use of linked presentation. In the case of a quasi-subidiary, linked presentation should be used in the consolidated balance sheet if the requirements that need to be met can be satisfied by the group (Para. 32). The difference in the case of a legal subsidiary is that linked presentation should only be used on the consolidated balance sheet if it is also applicable to the subsidiary's own balance sheet; in other words, all the conditions need to be met by the subsidiary itself. This particular refinement is required in order to comply with the Companies Act under which the subsidiary is part of the group as legally defined, and hence its assets and liabilities are assets and liabilities of the group and need to be treated in the consolidation in the normal way (Para. 102).

The section of FRS 5 on quasi-subidiaries does not incorporate any major items of principle, unless the point about linked presentation discussed above is regarded as such, but mainly provides guidance and authority on the use of the override principle of the Companies Act.

Summary of FRS 5

The main elements of the standard have been dealt with in the text but we will summarise the main points in the following list:

- 1 The substance of transactions should be recorded; greater weight should be given to aspects that are likely to have a commercial effect.
- 2 Complex transactions should be analysed to see whether the entity's assets or liabilities have been affected.
- 3 If assets and liabilities are identified then general tests need to be applied to see whether they should be recognised. Reference may also need to be made to other FRSS, SSAPs or statute.
- 4 Essentially there are four possible outcomes to the analysis:
 - (a) record the asset and liability separately;
 - (b) apply linked presentation;
 - (c) offset (very rare);
 - (d) ignore the transaction.
- 5 Adequate disclosure is required, in particular (i) where the asset or liability recognised in the financial statements differs in some respects from the generality of assets and liabilities, and (ii) where, although identified, assets or liabilities are not recognised in the primary and financial statements.
- 6 Quasi-subidiaries should be treated in much the same way as legal subsidiaries.

FRS 5 application notes

There are five application notes covering: consignment stock; sale and repurchase agreements; factoring of debts; securitised assets; and loan transfers. Each application note has three sections: features which describe the nature of the transaction; analyses of the transaction in terms of the framework of FRS 5; and required accounting which is the proposed

standard covering recognition in the financial statements and disclosure in the notes. In addition each application note contains tables and illustrations that are intended for general guidance and which do not form part of the proposed standard.

Compliance with international accounting standards

There is no specific international accounting standard on this subject but a number of the provisions of FRS 5 can be related to certain international standards, of which the following are the more important:

- The provision in IAS 1 *Presentation of Financial Statements*, that departure from a specific requirement of IASs, is permitted, albeit only in exceptional circumstances.⁵
- The criteria for the recognition of assets and liabilities found in FRS 5 mirror those appearing in IAS 16.
- The offsetting provisions of FRS 5 differ from those of IAS 32 *Financial Instruments: Disclosure and Presentation*, in that the latter imposes somewhat less rigid criteria for offset to be applied. For example IAS 32 does not require the right of offset to be capable of surviving the insolvency of the other party.
- The conditions under which quasi-subidiaries would be consolidated under the provisions of FRS 5 are similar to those laid down for the consolidation of special-purpose entities (SPEs) in SIC 12 *Consolidation – Special Purpose Entities*.⁶

Postscript to FRS 5

The provisions of FRS 5 are complex, as are the features of the transactions that it seeks to control. The provisions apply only to a small minority of financial statements but, where they do apply, their effect is often significant because complex transactions typically involve large amounts. The aim of the ASB in attempting to minimise off-balance-sheet financing is entirely laudable and the provisions of FRS 5 provide a set of principles that seem to be sufficiently comprehensive and robust to cope with the increasing ingenuity of the capital market.

Leases

Leasing and hire purchase agreements

To illustrate the issues involved in accounting for leases consider the affairs of Joel Jetway, the Managing Director of Creditor Airways. On Monday morning, because his car had broken down, his company rented a car for him for five days, in the afternoon the company signed a lease to 'rent' an aircraft for five years. The legal relationship between the two parties is the same in each case; the original owner, *the lessor*, retains title to the asset but allows, in exchange for suitable financial compensation, *the lessee* to have sole use of the asset⁷ for the period stated in the agreement. Should the two contracts be accounted for in the same way?

⁵ IAS 1, Paras 13 and 17. It is perhaps worth noting that US GAAP provides no similar override from the need to comply with the requirements of accounting standards.

⁶ SIC 12 is an Interpretation of the Standing Interpretation Committee of, in this case, IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*.

⁷ The agreement might, however, allow the lessee to sublet the asset to others.

Prior to the issue of SSAP 21 in 1984 they would, in the UK, have probably been treated in the same way. Nothing would appear in the lessee's balance sheet as the rental payments would be shown as an expense in the profit and loss account. SSAP 21 changed all that and, as we shall describe later, prescribed that certain leases, known as *finance leases*,⁸ should be regarded not as a rental agreement but as if the asset had been purchased on credit. Thus on the signing of the lease the balance sheet of the lessee would include an asset and a liability and the payments made to the lessor would be split between finance costs and repayment of the liability. More recently the view has emerged, both in the UK and overseas, that it is unrealistic to attempt to make such a distinction and that all non-cancellable leases should be treated as finance leases, our motor car example escaping this treatment purely on the grounds of materiality. This approach has, however, not as yet, emerged in an exposure draft.

We start this section of the chapter by describing some of the main forms of leasing and hire purchase agreements. Under a hire purchase agreement the user has the option to acquire the legal title to the asset upon the fulfilment of the conditions laid down in the contract, usually that all the instalments are paid. By contrast, under a leasing agreement in the UK no legal title passes to the lessee at any time either during the currency of the lease or at its termination. The lessor rents the asset to the lessee for an agreed period and, although the lessee has the physical possession and use of the asset, the legal title remains with the lessor.

In some cases a lease will be for a relatively short period in the life of the particular asset and the lessor may lease the same asset for many short periods to different lessees and in such cases the lessor will usually be responsible for the repairs and maintenance of the asset. This type of lease is described as an operating lease. In other instances the lease may be for virtually the whole life of the asset with the lessor taking the whole of its profit from one transaction; such a lease is known as a finance lease. Typically, the lessee of a finance lease will in practical terms treat the leased asset in very much the same way as it would an owned asset; the lessee, for example, will often be responsible for the asset's repair and maintenance.

One of the major principles underlying SSAP 21 *Accounting for Leases and Hire Purchase Contracts*, is that a distinction can and should be drawn between finance and operating leases and that they should be subject to different accounting treatments. However, the view is emerging in the international accounting standards community that, for both conceptual and practical reasons, the distinction should not and cannot be made and that all non-cancellable leases should be treated as finance leases. We will discuss both the SSAP 21 approach and the more recent alternative view in the course of this chapter.

Basic accounting principles

Operating leases

For the accountant, operating leases pose few problems. Amounts are payable for the use of an asset. From the point of view of the lessee, the amounts payable are the costs of using an asset for particular periods and hence are charged to the profit and loss account using the accruals concept. So far as the lessor is concerned the amounts receivable represent revenue from leasing the asset and are credited to the profit and loss account. The leased asset is treated as a fixed asset by the lessor and depreciated in accordance with normal policy.

⁸ This is the term used by the ASB and IASC; in the USA and Canada finance leases are called capital leases or sales type leases.

Finance leases

Lessees

Accounting for finance leases is a little more complicated. Prior to the introduction of SSAP 21, finance leases were usually treated by both lessee and lessor in the same way as operating leases. However, it was widely recognised that such treatment, while being justified on a strict legal interpretation of the agreement, failed to recognise the financial reality or substance of the transaction. The substance of the transaction was that the lessee acquired an asset for its exclusive use with finance provided by the lessor; which in economic terms has few (if any) differences from the case of an asset purchased on credit. If financial statements are to be 'realistic' it is necessary to find a way of accounting for finance leases which accords with the reality of the transaction rather than its legal form. As we saw earlier in this chapter the general issue is the subject of FRS 5 *Reporting the Substance of Transactions*, but, because of the growth of the leasing industry and the distorting effects of the then prevalent accounting treatment, the ASC issued SSAP 21 in advance of a comprehensive standard. Fortunately SSAP 21 is consistent with the provisions of FRS 5. The IASB also specifically requires that the substance and financial reality of a transaction, rather than its legal form, should determine the appropriate accounting treatment.⁹

The appropriate treatment of a finance lease, which accords with the substance of the transaction is, from the point of view of the lessee, to include in the lessee's balance sheet an asset representing the lease and a liability representing the obligation to make payments under the terms of the lease. At the inception of the lease the asset would be equal to the liability but this relationship does not hold thereafter. The asset would be depreciated over the shorter of its useful economic life and the length of the lease, while the liability would be eliminated by the payments. These payments are not, as in the case of an operating lease, charged entirely to the profit or loss account nor are they, in general, wholly set off against the liability. Instead the payments are split between that element which is regarded as representing the repayment of the liability and the remainder that is debited to the profit and loss account as the financing (or interest) charge. This approach is referred to as the capitalisation of the lease.

The lack of a faithful representation consequent upon the failure of a lessee to capitalise financial leases is highlighted by the problems that would be experienced when comparing two companies, one of which leases most of its assets, with the other purchasing fixed assets using loans of one sort or another. The latter company's balance sheet would show the assets which it used to generate its revenue thus allowing users of accounts to estimate the rate of return earned on those assets, whereas the former company's balance sheet would, if the leases were not capitalised, understate its assets. Similarly, the latter company's balance sheet would indicate the liabilities that would have to be discharged if it is to continue in business with its existing bundle of assets, whereas the former company's balance sheet would not.¹⁰

Lessors

We have so far considered only how the lessee should treat a finance lease. Let us now consider the matter from the point of view of the lessor. In the case of a finance lease the lessor's balance sheet would not include the physical asset but a debtor for the amounts receivable under the lease. Thenceforth the payments received under the terms of the lease should be

⁹ IAS 1, Paras 9b and 17.

¹⁰ It is for this reason that finance leases were described as providing an 'off balance sheet' source of finance.

split between that which goes to reducing the debt and the balance being credited to the profit and loss account. We shall see later in this section how the division can be made.

The principles illustrated

Lessees

We will start by examining the treatment of finance leases in the books of the lessee. This will not only enable us to show the basic principles involved but also introduce some terms which will make it easier to understand SSAP 21.

We will look at two examples. The first involves annual rental payments while the second involves more frequent rental payments, in our example six monthly payments, which brings an additional complication.

Example 9.1 An illustration of the basic principles of accounting for a finance lease in the accounting records of a lessee

Lombok Limited, a company whose year end is 31 December, leases a machine from Salat Limited on 1 January 20X1. Under the terms of the lease Lombok is to make four annual payments¹¹ of £35 000 payable at the start of each year. Lombok Limited is responsible for all the maintenance and insurance costs, so these are not covered by the payments under the lease.

The first step is to decide the amount at which the leased asset should be capitalised, i.e. shown as an asset and a liability in the first instance. SSAP 21 requires that:

At the inception of the lease the sum to be recorded both as an asset and as a liability should be the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease. (Para. 32)

To do that we need to know what is meant by the minimum lease payments and the interest rate implicit in the lease. These terms are as defined in SSAP 21.

Minimum lease payments

The minimum lease payments are the minimum payments over the remaining part of the lease term (excluding charges for services and taxes to be paid by the lessor) and:

- (a) in the case of the lessee, any residual amounts guaranteed by him or by a party related to him; or
- (b) in the case of the lessor, any residual amounts guaranteed by the lessee or by an independent third party. (Para. 20)

In the Lombok example we will assume that there are no residual amounts and thus the minimum lease payments at the inception of the lease are the four annual payments of £35 000.

¹¹ In practice lease payments are usually made at monthly, quarterly or six-monthly intervals, but, in order to illustrate more clearly the principles involved, in our example we will assume that the payments are made at annual intervals. Example 9.2 explains the treatment of six monthly rentals, and even more realistic examples of the type of calculations that have to be made in practice, including leases which do not, conveniently, start on the first day of the year, may be found in the guidance notes to SSAP 21.

Interest rate implicit in a lease

The interest rate implicit in a lease is the discount rate that at the inception of a lease when applied to the amounts that the lessor expects to receive and retain produces an amount (the present value) equal to the fair value of the leased asset. The amounts which the lessor expects to receive and retain comprise (a) the minimum lease payments to the lessor (as defined above) plus (b) any unguaranteed residual value, less (c) any part of (a) and (b) for which the lessor will be accountable to the lessee. If the interest rate implicit in the lease is not determinable, it should be estimated by reference to the rate that a lessee would be expected to pay on a similar lease. (Para. 24)

A key element in the above definition is fair value and hence we need to know how this is found.

Fair value

Fair value is the price at which an asset could be exchanged in an arm's length transaction less, where applicable, any grants receivable towards the purchase or use of the asset. (Para. 25)

Note that while knowledge of the implied interest rate is required to determine the appropriate accounting treatment in the books of the lessee, it is found by reference to the cash flows of the lessor. In practice the lessee may not know or be able to estimate the various cash flows but we assume, at this stage, that the lessee can obtain all the necessary data.

If we let FV be the fair value, L_j the lease payment in year j (payable at the beginning of each year) and R_n the estimated residual values received at the end of year n , the last year of the lease, then using standard present value techniques the implied rate of interest r is found from the solution of the following equation:

$$FV = \sum_{j=0}^{n-1} \frac{L_j}{(1+r)^j} + \frac{R_n}{(1+r)^n}$$

If we assume in the case of the Lombok/Salat lease that the fair value is £108 720 and that there is no residual value (i.e. $R_n = 0$) then substituting in the above equation we get:

$$£108\,720 = \sum_{j=0}^3 \frac{£35\,000}{(1+r)^j} \text{ or } \sum \frac{1}{(1+r)^j} = 3.1064$$

Inspection of tables showing the present value of an annuity shows that 3.1064 represents an interest rate of 20 per cent.¹² Thus the interest rate implicit in the lease is 20 per cent and hence the present value PV of the minimum lease payments can be found as follows:

$$\begin{aligned} PV &= £35\,000(3.1064) \\ &= £108\,720 \end{aligned}$$

This is of course equal to the fair value as, in the simple case, the only cash flows that the lessor will receive are the minimum lease payments. Later we will describe the circumstances where the two series of cash flows (i.e. the lessee's and the lessor's) might be different and the effect of these differences on the calculations.

We can now show how the lease should be treated in the books of Lombok (the lessee). The original entry recording the lease is:

¹² This and other necessary present value calculations can be made by use of standard computer packages. Care is needed if using a table or a program that assumes all cash flows take place at the end of a period. In this example the cash flows take place at the start of the period. This problem can be overcome by noting that the present value factor for an immediate payment is 1, and so deduct 1 from 3.1064 to give 2.1064 which when applied to the three remaining payments produces an interest rate of 20 per cent.

Dr Leased asset	£108 720	
Cr Liability under lease		£108 720

From this time onwards the two accounts are dealt with separately. The leased machine will be depreciated over the shorter of the length of the lease or the asset's expected life, using the company's normal depreciation policy for assets of its type, while the liability will be gradually extinguished as payments are made during the primary period of the lease. The only problem that remains is how to spread the total interest charge over the primary period of the lease. This same problem is, of course, encountered in accounting for hire purchase transactions.

The total interest charge may be calculated as follows:

	£
Payments under lease, 4 × 35 000	140 000
less 'Cost' as above	108 720
Interest	<u>31 280</u>

Theoretically, the best approach is to use the actuarial or annuity method that produces a constant annual rate of interest (in this case 20 per cent) on the outstanding balance on the liability account. This is the method specified in SSAP 21, which does, however, allow the use of any alternative method that is a reasonable approximation to the annuity method.¹³

Assuming that all payments are made on the due dates, the liability account in the books of Lombok for the term of the lease can be summarised as follows:

	20X1	20X2	20X3	20X4
	£	£	£	£
1 Jan Opening balance (20X1 cost)	108 720	88 470	64 170	35 000
1 Jan Cash	<u>35 000</u>	<u>35 000</u>	<u>35 000</u>	<u>35 000</u>
	73 720	53 470	29 170	–
31 Dec Interest, 20% of above	<u>14 750</u>	<u>10 700</u>	<u>5 830</u>	<u>–</u>
31 Dec Closing balance	<u>88 470</u>	<u>64 170</u>	<u>35 000</u>	<u>–</u>

This account provides us with the interest charge to the profit and loss account for each year and the liability for inclusion in each balance sheet. The amount of interest charged to the profit and loss account declines over the life of the lease because the outstanding balance is reduced by the annual payments. It is, of course, necessary to distinguish between the current portion of the liability, that is the amount due to be paid in the coming twelve months, and the long-term liability for the purposes of balance sheet presentation. In this case, this is extremely easy as the only payment to be made in each of years 20X2 and 20X4 is £35 000 per annum payable on the day following each balance sheet date. Hence the analysis of the liability into its current and long-term components is as follows:

	20X1	20X2	20X3	20X4
	£	£	£	£
Closing liability as shown above	88 470	64 170	35 000	–
Current portion of liability	<u>35 000</u>	<u>35 000</u>	<u>35 000</u>	<u>–</u>
Long term portion of liability – balance	<u>53 470</u>	<u>29 170</u>	<u>–</u>	<u>–</u>

¹³ The method is the only one permitted under the provisions of FRS 4 *Capital Investments*.

Example 9.2 will explain the complication that arises in analysing this liability where rental payments are made more frequently than once a year.

One commonly used alternative to the annuity method is the 'sum of the year's digits' method or 'Rule of 78'.¹⁴ If the sum of the digits method were used in the above illustration the results would be:

Total interest charge	<u>£31 280</u>
Sum of the year's digits, 1 + 2 + 3	<u>6</u>
Interest charged to profit and loss account	
20X1, $\frac{3}{6}$ of £31 280	15 640
20X2, $\frac{2}{6}$ of £31 280	10 430
20X3, $\frac{1}{6}$ of £31 280	<u>5 210</u>
	<u>£31 280</u>

Although the use of the annuity method is conceptually superior, a comparison of the annual interest charges under the two methods reveals similar patterns of interest charge and thus the 'sum of the year's digits' method is often used as a convenient approximation to the annuity method:

Year	<i>Annuity method</i> (£)	<i>Sum of the year's digits method</i> (£)
20X1	14 750	15 640
20X2	10 700	10 430
20X3	<u>5 830</u>	<u>5 210</u>
	<u>£31 280</u>	<u>£31 280</u>

The impact of residual values

Let us now complicate matters by assuming that the asset that is the subject of the lease has a residual value. We will assume that the manufacturer who originally supplied the asset to Salat has agreed to reacquire the asset at the end of the lease. The sum is dependent on the condition of the machine and the market factors at the end of the lease, but the manufacturer has guaranteed to pay £10 000 whatever the circumstances. Let us assume that at the inception of the lease it is anticipated that the manufacturer will actually pay £20 000. Let us also assume that Lombok and Salat agree that they will divide any sums realised on the disposal of the asset in the ratio 35:65. Thus, at the inception of the lease it is estimated that Lombok will receive £7000 (of which £3500 is guaranteed) and Salat £13 000 (£6500 guaranteed).

For the purposes of calculating the implicit interest rate, the distinction between the guaranteed and unguaranteed elements of the residual value can be ignored as both have to be

¹⁴ It is called the Rule of 78 because if the method is based on the monthly intervals and if the digit 1 is assigned to January, 2 to February and so on, the sum of the digits for the year is 78.

taken into the calculation, but the distinction may be important when deciding whether the lease is a finance or operating lease (see p. 225).

If we return to the equation on p. 218 and substitute the estimated value on realisation receivable by Salat, the equation becomes:

$$£108\,720 = \sum_{j=0}^3 \frac{35\,000}{(1+r)^j} + \frac{13\,000}{(1+r)^4}$$

Use of tables or a programmable calculation on a computer shows that the above equation will be satisfied when r is approximately 25 per cent. This is a higher rate of interest than the 20 per cent that was previously calculated as Salat obviously earns a higher return due to the introduction of the residual value as an additional cash flow.

So far as Lombok is concerned the minimum lease payments are unchanged but they will now be discounted at the higher rate of 25 per cent that will produce an initial value of the leased asset of:

$$£35\,000(2.952) = £103\,320$$

The annual payments of £35 000 are the same as in the original example except that the liability that is to be paid off is lower (£103 320 not £108 720). Hence the finance charge in the profit and loss account will be higher in the second example. This reflects the fact that in the first example the lease payments can be regarded as acquiring the whole of the productive use of the asset, in that a zero residual value was assumed, whereas in the second case the same annual lease payments only acquired a proportion of the asset's productive capacity.

It will be noted that the estimated realisable value that Lombok expects to receive had no effect on the calculation of the amount by which the lease should be capitalised or on the way in which the annual lease payments should be split. This is because these depend on the minimum lease payments. The recognition of the estimated realisable value does have an effect on the amount that has to be depreciated which is the present value of the minimum lease payments less the estimated realisable value. Thus, the depreciation charges that would emerge from our two sets of assumptions are as follows (assuming the straight-line method is used):

$$\text{Assumption 1} \quad \frac{£108\,720}{4} = £27\,180$$

$$\text{Assumption 2} \quad \frac{£(103\,320 - 7\,000)}{4} = £24\,080$$

In the above examples we assumed that the lessee knows (or is able to find out from the lessor) the fair value of the asset and the estimated realisable value that the lessor expects to receive. In practice this may well not be the case and certain estimates will have to be made. Often the fair value will be known¹⁵ and the interest rate estimated from a knowledge of other leases of a similar type.

¹⁵ Unless the asset concerned is highly specific the prudent lessee will obviously wish to know how much it would cost to purchase the asset before signing a lease.

Example 9.2 Illustration of capitalisation of finance lease involving more frequent rental payments

In this example, we explain how to account for finance leases that involve rental payments occurring more frequently than once a year.

Java plc, whose year end is 31 December, entered into a non-cancellable agreement, on 1 July 20X1, to lease a machine for a period of five years. Payments under the lease are £55 200 payable six monthly commencing on 1 July 20X1. The interest rate implicit in the lease is 8 per cent per half year.

The fair value of the machine at 1 July 20X1 was £420 000.

Java plc uses straight-line depreciation applied on a strict time basis.

We need first to work out the present value of the minimum lease payments.

$$\begin{aligned}
 \text{PV of the minimum lease payments} &= £55\,200 (1 + \text{PV of annuity of 1 per period for nine periods}) \\
 &= £55\,200 (1 + a_{\overline{9}|} \text{ at } 8\%) \\
 &= £55\,200 (1 + 6.247) \\
 &= \underline{\underline{£400\,000}} \text{ approximately.}
 \end{aligned}$$

The initial cost of the machine and the initial obligation should therefore be recorded at £400 000.

The lessee has the possession and use of the machine for five years so the annual depreciation using the company's method would be £80 000 (£400 000/5). In the year ended 31 December 20X1, Java has only had the use of the machine for six months and hence the depreciation should be £40 000. In summary, the machine will be depreciated over the term of the lease as follows:

		£
Depreciation	20X1	40 000
	20X2	80 000
	20X3	80 000
	20X4	80 000
	20X5	80 000
	20X6	40 000
		<u>£400 000</u>

A summary of the liability account for the first two years of the lease will appear as follows:

<i>Period half-year</i>	<i>Opening balance</i>	<i>Payments on first day of period</i>	<i>Net amount on which interest is payable for each period</i>	<i>Interest at 8% per period</i>	<i>Closing balance</i>
	£	£	£	£	£
1 July–31 Dec 20X1	400 000	55 200	344 800	27 584	372 384
1 Jan–30 June 20X2	372 384	55 200	317 184	25 375	342 559
1 July–31 Dec 20X2	342 559	55 200	287 359	22 989	310 348
1 July–31 Dec 20X3	310 348	55 200	255 148	20 142	275 560

The finance cost to be charged to the profit and loss account for the year ended 31 December 20X1 is £27 584 while that to be charged for the year to 31 December 20X2 will be £25 375 + £22 989 = £48 364.

The liability at 31 December 20X1 is £372 384 but we need to analyse this into its current and non-current portions for presentation in the balance sheet. One payment of £55 200 will be made on the following day, 1 January 20X2, so this will definitely reduce the liability at 31 December

Barriers to the introduction of a standard

In order to understand part of the reason why leasing became popular, the reluctance on the part of most companies to capitalise leases and the provisions of SSAP 21, it is necessary to understand the way in which leases were in the past treated for the purposes of taxation. Unlike hire purchase contracts and credit sales agreements, where the user obtains grants and capital allowances, in a lease it is the legal owner, the lessor, who received grants and capital allowances on the asset. The lessee received no allowances but obtained tax relief on the amounts payable under the lease. Capital allowances are only of value to a company that has sufficient taxable profit. Hence, to their mutual advantage, one company with large taxable profits was able to lease assets to another company that did not have sufficient taxable profits to take full advantage of capital allowances. Thus the company with insufficient taxable profits could acquire fixed assets at a lower effective cost than would have been the case with alternative methods of financing.

The effect of what might well be described as the distortion of the tax system described above was undoubtedly one of the major causes of the growth of leasing. Hence, there was a good deal of opposition to the proposal that lessees should capitalise finance leases, as it was feared that a change in accounting practice might precipitate changes in taxation law whereby finance leases would be treated in the same way as hire purchase contracts.

Other factors which hindered the development of a standard requiring the capitalisation of finance leases included concerns about the possible extension of the principle to other types of non-cancellable contracts, for example those for the regular supply of raw materials or labour, and fears about the potential complexity of any standard. However, the ASC did issue SSAP 21 *Accounting for Leases and Hire Purchase Contracts* in August 1984 and, amongst other things, this required lessees to capitalise finance leases, and lessors to include in their balance sheets not the fixed asset but the debtor for the net investment in the lease.

It is perhaps somewhat ironic that, after studying the problem for some nine years, the ASC issued this standard just after the Finance Act 1984 had considerably reduced the tax advantages of leasing.

SSAP 21 Accounting for Leases and Hire Purchase Contracts

We are now in a position to discuss the specific requirements of SSAP 21. This is a detailed standard and we will not attempt to cover all its aspects but will instead concentrate on the important elements and those that might give rise to particular difficulties of understanding. The ASC published guidance notes on SSAP 21 and readers should refer to this booklet for a more detailed explanation of the provisions of the standard.

We will first deal with a number of general issues before concentrating on the impact of the standard on the accounts of lessees and hirers. A discussion of the more specialised topic of accounting for lessors will be deferred until later in the chapter.

Scope

The standard covers leases and hire purchases contracts and is applicable to accounts based on both the historical cost and current cost conventions. The standard does not apply to leases of the rights to exploit natural resources such as oil or gas, nor does it apply to licensing agreements for items such as motion pictures, videos, etc. Stress is also laid on the point that the standard does not apply to immaterial items, such as car rental, as discussed earlier.

Distinction between finance and operating leases

The apparent distinction between the two different types of leases has already been explained (see p. 215). The standard states that:

A finance lease is a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. (Para. 15)

It is presumed that a lease is a finance lease if at the start of the lease the present value of the minimum lease payments amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset. The present value should be calculated by using the interest rate implicit in the lease. However, the standard recognises that in exceptional circumstances this initial presumption may be rebutted if the lease in question does not transfer substantially all the risks and rewards of ownership to the lessee. Sometimes the lessor will receive part of its return by way of a guarantee from an independent third party, possibly the manufacturer of the asset, in which case the lease may be treated as a finance lease by the lessor but as an operating lease by the lessee.

There is nothing magic about using 90 per cent as a cut-off point, and the need to resort to the use of what is essentially an arbitrary criterion is one of the arguments used to support the view that there is no distinction to be made between the two different types of lease.

Hire purchase contracts

With the vast majority of hire purchase contracts the 'risks and rewards' pass to the hirer and hence may be regarded as being akin to finance leases. In such cases the standard specifies that they should be treated in a similar way to finance leases. However, in exceptional circumstances a hire purchase contract may be accounted for on the same principles as an operating lease.

Accounting by lessees

Finance leases

A finance lease should be capitalised; hence the lease should be recorded as an asset and an obligation to pay rentals. At the inception of the lease the asset will equal the liability (although this equality will not hold over the life of the lease) and will be the present value of the minimum lease payments, derived by discounting them at the interest rate implied in the lease.

The standard states that:

the fair value of the asset will often be a sufficiently close approximation to the present value of the minimum lease payments and may in these circumstances be substituted for it. (Para. 33)

If the fair value cannot be determined, possibly because the asset concerned is unique, then the present value can be found by discounting the minimum lease payments by the interest rate implicit in the lease. If the latter cannot be determined the rate may be estimated from that which applied in similar leases.

Total payments less than fair value

In some circumstances the combined impact of any grants which may be available and taxation allowances received by the lessor may be such as to bring the total (i.e. not the present value of) lease payments below the fair value. The standard specifies (Para. 34) that if this

occurs the amount to be capitalised and depreciated should be reduced to the minimum lease payments. A negative finance charge should not be shown.

In other words if, say, the total of the payments to be made under the lease is £10 000 and the fair value of the asset is £12 000, the asset and liability on the inception of the lease are both £10 000. The payments under the lease will all be applied to reducing the liability and no part of them will be charged to the profit and loss account as a finance charge. The only charge in the profit and loss account will be the annual depreciation charge.

Rentals

Rentals payable should be apportioned between the finance charge (if any) and a reduction of the outstanding obligation. The total finance charge should be allocated to accounting periods so as to produce a constant annual rate of charge (i.e. the annuity method), or a reasonable approximation thereto.

The guidance notes suggest that in most circumstances, especially where the lease is for seven years or less and interest rates are not high, the Rule of 78 (see p. 220) will be an acceptable approximation to the actuarial method. In the case of small (relative to the size of the companies) leases it is suggested that the straight-line method, whereby the total finance charge is recognised on a time basis, may be acceptable.

Note that FRS 4 *Capital Instruments* does not give any latitude as to use of the method of allocating finance charges (or finance costs as they are called in FRS 4); only the actuarial (or annuity) method is allowed. However, the concept of materiality could be cited to justify the use of a simpler method such as the Rule of 78 if the figures produced by the two methods are fairly close or the totals are not material in the context of the entity's total operation.

Depreciation

A leased asset should be depreciated over the shorter of the length of the lease or the asset's useful life. However, in the case of hire purchase contracts, because of the presumption that the asset concerned will be acquired by the hirer, the asset should be depreciated over its useful life.

Operating leases

The accounting treatment by the lessee in respect of operating leases is straightforward in that the whole of the payments are charged to the profit and loss account. The only slight complication is that the standard requires the rental to be charged on a straight-line basis over the lease term (unless another systematic and rational basis is more appropriate) even if the payments are not made on such a basis. Hence, if the term of the lease requires a heavy initial payment, a proportion of the payment can be treated as a prepaid expense.

More commonly, lessees are granted so-called 'rental holidays' in that they do not have to pay anything for an initial period. In such circumstances the standard requires a charge to be made to the profit and loss account for the period of the rental holiday that would be treated as an accrual in the balance sheet. Thereafter the charge to the profit and loss account would be less than the payments made in the year (as rental, like other holidays, has to be paid for), with the excess reducing the balance sheet accrual. Particularly significant examples of this type of arrangement are leases of buildings by government agencies to business in areas where the government wants to encourage the creation of jobs.

Disclosure requirements in the financial statements of lessees and hirers

Finance leases

For disclosure purposes information relating to hire purchase contracts with characteristics similar to finance leases should be included with the equivalent information regarding leases.

- 1 *Fixed assets and depreciation.* The lessee may either:
 - (a) show separately the gross amounts, accumulated depreciation and depreciation expense for each major class of leased asset; or
 - (b) group the above information with the equivalent information for owned assets¹⁶ but show by way of a note how much of the net amount (i.e. net book value) and the depreciation expense relates to assets held under finance leases.
- 2 *Obligations.* The lessee must both:
 - (a) disclose the obligations related to finance leases separately from other obligations and liabilities; and
 - (b) analyse the net obligations under finance leases into three components (the figures may be combined with other obligations):
 - amounts payable in next year;
 - amounts payable in second to fifth years;
 - amounts payable thereafter.
- 3 *Finance charges.* The lessee must disclose the aggregate finance charge allocated to the period.
- 4 *Commitments.* The lessee must show by way of a note the amount of any commitment existing at the balance sheet date in respect of finance leases which have been entered into but whose inception occurs after the year end.
- 5 *Accounting policies.* Accounting policies adopted for finance leases must be stated.

Operating leases

- 1 *Current rentals.* The lessee must disclose the total rentals charged as an expense, analysed between amounts payable in respect of the hire of plant and machinery and those charged in respect of other operating leases. (The Companies Act, of course, requires disclosure of the charge for the hire of plant and machinery.)
- 2 *Future rentals.* The lessee must show the payments which it is committed to make during the next year, analysed between those in which the commitment expires:
 - (a) within that year;
 - (b) in the second to fifth years inclusive; and
 - (c) over five years from the balance sheet date.
 Commitments in respect of leases of land and buildings and other operating leases must be shown separately.
- 3 *Accounting policies.* The accounting policies adopted for operating leases must be stated.

Accounting for finance leases by lessors – general principles

The provisions of SSAP 21 regarding the accounting treatment of finance leases by lessors are relatively difficult for two main reasons. First, the basic method is itself not simple since – as will be shown – it depends on complex calculations of what constitutes the lessor's

¹⁶ Since it is the right to use the asset rather than the asset itself which is capitalised there is some doubt as to whether it should be called a tangible asset and included with the owned tangible assets. The ASC ignored such niceties and for the purposes of balance sheet presentation the leases are regarded as tangible assets.

investment in a particular lease and, second, the standard permits the use of alternative methods and simplifying assumptions so that a host of different methods can be justified under the terms of the standard.

We will first describe the basic principles underlying the provisions of SSAP 21 relating to the treatment of finance leases by lessors.

Balance sheet presentation – the measurement of net investment

Lessors should not include in their balance sheets the assets subject to the contracts which are finance leases but instead record as a debtor the *net investment* in the lease after making any necessary provisions for bad and doubtful debts. In order to explain this term and describe how profit is recognised, we will need to reproduce certain definitions included in SSAP 21.

Net investment

The net investment in a lease at a point in time comprises:

- (a) the gross investment in a lease; less
- (b) gross earnings allocated to future periods. (Para. 22)

Thus, we need to know what is meant by the gross investment and gross earnings.

Gross investment

The gross investment in a lease at a point in time is the total of the minimum lease payments [see p. 217] and any unguaranteed residual value accruing to the lessor. (Para. 21)

Gross earnings

Gross earnings comprise the lessor's gross finance income over the lease term, representing the difference between his gross investment in the lease [see above] and the cost of the leased asset less any grants receivable towards the purchase or use of the asset. (Para. 28)¹⁷

In order to illustrate the effect of the above definitions assume that the details relating to a particular lease are as follows:

Cost of asset	£12 000
Grant receivable by lessor	£2 000
Lease term	5 years
Annual rental	£3 000
Estimated residual value accruing to the lessor	£500

Let us see how one measures the net investment at the inception of the lease and at the end of the first year.

<i>At inception:</i>	£
Minimum lease payments, 5 × £3000	15 000
Estimated residual value	500
Gross investment	15 500
less Gross earnings (£15 500 – £10 000)	5 500
Net investment	<u>£10 000</u>

¹⁷ The paragraph goes on to modify the definition to deal with the use of a possible option available in SSAP 21 relating to the treatment of tax-free grants.

Hence, at inception the net investment is equal to the cost of the asset less grants receivable by the lessor.

Assume that the gross earnings recognised in the profit and loss account in the first year are £2500 (we shall describe in the following section how this figure is calculated). Then the net investment at the end of the first year is:

	£
Minimum lease payments, 4 × £3000	12 000
Estimated residual value	<u>500</u>
	12 500
<i>less</i> Gross earnings allocated to future periods (£5500 – £2500)	<u>3 000</u>
Net investment	<u><u>£9 500</u></u>

The recognition of gross earnings

The total gross earnings on any lease are reasonably easy to calculate since the minimum lease payments will be known and, generally, the residual value, if any, can be estimated. The difficulty lies in allocating the gross earnings to the different accounting periods. The standard followed existing practice in the leasing industry by specifying that (other than in the case of hire purchase contracts) the interest should be allocated on the basis of the lessor's *net cash* investment in the lease and not on the basis of the net investment. Specifically, Para. 39 of SSAP 21 states:

The total gross earnings under a finance lease should normally be allocated to accounting periods to give a constant periodic rate of return on the lessor's net cash investment in the lease in each period. In the case of a hire purchase contract which has characteristics similar to a finance lease, allocation of gross earnings so as to give a constant periodic rate of return on the finance company's net investment will in most cases be a suitable approximation to allocation based on the net cash investment. In arriving at the constant periodic rate of return, a reasonable approximation may be made.

To an extent the above is familiar in that it is the counterpart of the annuity method prescribed for use by lessees in that the annual finance charge should be such as to produce a constant rate based on the decreasing obligation. The difference is that although the reduction in the obligation is relatively easy to calculate, the determination of the net cash investment is somewhat more difficult.

The meaning of net cash investment

The meaning of the net cash investment can be more easily understood if one assumes that a separate company is established by the lessor for each lease and then measuring or estimating the cash flows in and out of that company. The net cash investment is then the balance of cash, which might be positive or negative, in the company at any point in time. The various cash flows may be summarised as in Table 9.2.

If one thinks in terms of a single lease company and the cash flows associated with it, it can be seen that the company will start with an 'overdraft' – the cost of the asset and of setting up the lease – but that this will be reduced if a grant is received and as capital allowances for the purchase of the asset are received. The overdraft will be reduced as lease payments are received but will be increased by virtue of the interest payments made on the overdraft. Profit may also be withdrawn (and for this purpose profit may be regarded as including the

Table 9.2 Summary of cash flows

<i>Cash flows out</i>	<i>Cash flows in</i>
1 Cost of the asset	(a) Grants received against purchase or use of asset
2 Cost of setting up the lease	(b) Rental income received
3 Tax payments on rental and interest received	(c) Tax reductions on capital allowances* and on interest paid
4 Interest payments on cash invested in the lease	(d) Interest earned when the net cash investment becomes a surplus
5 Profit withdrawn	(e) Residual value at the end of the lease

*Since in actuality the 'single-lease' company is not separate and distinct, the reductions in tax payments due to the receipt of capital allowance and the charging of expenses can be treated as cash receipts since they are covered by tax payment otherwise payable by the lessor (if this were not the case the lessor should not be in the leasing business in the first place).

contribution made by the 'single lease' company to the operating expenses of the enterprise of which it actually forms part) which will also increase the overdraft. At some stage the overdraft may be eliminated and replaced by a cash surplus on which interest may be deemed to be earned. The interest 'payments' and 'receipts' will also have taxation consequences that will respectively increase the cash surplus (or reduce the overdraft) or decrease the cash surplus. Finally, if the lessor receives a residual value this will increase the surplus.

It is on the basis of the above considerations that SSAP 21 defines net cash investment as follows:

The *net cash investment* in a lease at a point in time is the amount of funds invested in a lease by a lessor, and comprises the cost of the asset plus or minus the following related payments and receipts:

- (a) government or other grants receivable towards the purchase or use of the asset;
- (b) rentals received;
- (c) taxation payments and receipts, including the effect of capital allowances;
- (d) residual values, if any, at the end of the lease term;
- (e) interest payments (where applicable);
- (f) interest received on cash surplus;
- (g) profit taken out of the lease. (Para. 23)

The actuarial method after tax

The guidance notes to SSAP 21 describe a number of ways of allocating the gross revenue to accounting periods based on the net cash investment. Of these the most accurate is the 'actuarial method after tax'. This method produces a constant rate of return on the net cash investment over that period of the lease in which the lessor has a positive investment (i.e. before any cash surplus is generated). The phrase 'after tax' does not imply that it is after-tax profit which is allocated but simply that the tax cash flows are included in the measurement of the net cash investment.

The actuarial method after tax is illustrated in Example 9.3.

Example 9.3 The actuarial method after tax

Gasp plc, the lessor, acquired an asset for £7735 that it leased out on the following terms:

Period	5 years
Rental	£2000 per year payable in advance on 1 January of each year
Residual value	Zero

Gasp's year end is 31 December and tax in respect of any year is payable on 1 January of the next year but one. The tax rate is 50 per cent and capital allowances of 100 per cent are receivable in the first year. (These rates are unrealistic but they have been chosen to simplify the figures and hence clarify the example.)

The annual rate of return earned over the period when there is a net cash investment is 12 per cent while it is estimated that surplus cash can be invested at 5 per cent (both rates are before tax).

The interest paid by Gasp on the funds invested in the lease will be ignored.

The cash flows and the profit recognised on the lease are set out in Table 9.3.

Table 9.3 Hypothetical cash flows – figures in brackets represent cash flows out

Date	Cost £	Rent £	Tax £	Profit taken on lease £	Interest on cash surplus £	Net cash investment £
1 Jan X0	(7735)	2000				(5735)
31 Dec X0				(688)		(6423)
1 Jan X1		2000				(4423)
31 Dec X1				(531)		(4954)
1 Jan X2		2000	2868			(86)
31 Dec X2				(11)		(97)
1 Jan X3		2000	(1000)			903
31 Dec X3					45	948
1 Jan X4		2000	(1000)			1948
31 Dec X4					98	2046
1 Jan X5			(1023)			1023
31 Dec X5					52	1075
1 Jan X6			(1049)			26
1 Jan X7			(26)			–

Notes:

- The profit taken on the lease has been calculated at 12 per cent of the net cash investment at the start of each year (e.g. £688 = 0.12 × £5735) while the interest on the cash surplus has been calculated at 5 per cent of the opening balance (e.g. £45 = 0.05 × £903). Interest on the cash surplus in 20X6 has been ignored (otherwise the calculation would never end).
- The tax computation for 20X0 (tax payable on 1 January 20X2) is as follows:

	£
Capital allowances (100%)	7735
less Rental income received	<u>2000</u>
Adjusted profit	<u>5735</u>
Tax thereon, 50% of £5735	£2868

In subsequent years the tax payment is 50 per cent of the sum of the rental income and the interest earned on the cash surplus.

Although the lease will generate an annual rental of £2000 for each of the five years after tax, profit recognised in respect of the lease is £688 in year 1, £531 in year 2 and £11 in year 3.¹⁸

It may be thought that this is a very imprudent way of recognising profit in that most of the profit is taken in the first two years of the lease. However, it must be recognised that the profit reported is that which is generated by the lessor's financing activities and is calculated by reference to the amount that the lessor has invested in the lease. As Table 9.3 shows, the investment falls to zero, to be replaced by a cash surplus by 1 January 20X3.

Arithmetically all the figures in Table 9.3 can be found if you know the cash flows, which will be specified in the agreement, and either the profit on the lease (12 per cent) or the re-investment rate (5 per cent). Thus, if one of the two rates is known the other can be calculated, with the aid of a computer or a lot of patient trial and error. In practice, of course, the lessor will have made the calculations of these rates when agreeing the terms of the rental with the lessee. Thus the lessor would start by deciding, on the basis of market conditions and competitive forces, the return required on the lease (taking into account the return on any surplus cash invested¹⁹ and hence work out the rent that would need to be charged.

The next step is to calculate the proportion of the annual receipts of £2000, which is deemed to represent the reduction in the amount due from the lessee. The calculation is based on the figures in Table 9.4. This table also shows the necessary transfers to and from the deferred taxation account if it is judged necessary to establish such an account.

Table 9.4 To calculate capital repayment and deferred taxation transfers

	20X0	20X1	20X2	20X3	20X4	20X5	Total
	£	£	£	£	£	£	£
1 Rental	2000	2000	2000	2000	2000		10 000
2 Capital repayments	(624)	(938)	(1978)	(2045)	(2098)	(52)	(7 735)
3 Gross earnings	1376	1062	22	(45)	(98)	(52)	2 265
4 Interest				45	98	52	195
5 Profit before tax	1376	1062	22	-	-	-	2 460
6 Taxation	2868	(1000)	(1000)	(1023)	(1049)	(26)	(1 230)
7	4244	62	(978)	(1023)	(1049)	(26)	(1 230)
8 Deferred tax	(3556)	469	989	1023	1049	26	-
9 Net profit	£688	£531	£11	-	-	-	£1 230

Table 9.4 is constructed from the bottom up. The figures in line 9 are taken from Table 9.3. The net profit is then grossed up at the appropriate tax rate (50 per cent) to give line 5. Line 6, which shows the actual tax payments, is also taken from Table 9.3 which means that line 8 (deferred tax) can be derived. Line 4 is taken from Table 9.3 and hence the gross earnings (line 3) and capi-

¹⁸ Observant readers will note that the sum of these is, at £1230, more than the 50 per cent of the difference between the minimum lease payments and the cost of the asset, i.e. 50 per cent of (£10 000 - £7735) = £1132. This is because the interest on the cash surplus is included in the total profit, i.e. £1230 = 50 per cent of (£10 000 - 7735 + 45 + 98 + 52).

¹⁹ The surplus cash will probably be invested in another lease, thus the rate of return on the surplus cash will be the return from the new lease. The return on the new lease will depend *inter alia* on the return on any surplus cash it may generate which it may be presumed will be invested in yet another lease and so on *ad infinitum*. In practice, to avoid having to estimate returns on leases (or other investments) which will arise in the future, a prudent estimate of the return on surplus cash is used in the calculations.

tal repayments (line 2) can be deducted. If, taking into consideration the affairs of the company as a whole, it is decided that it is not necessary to account for deferred tax, one could start Table 9.4 at line 5 and work up from there.

It must be emphasised that Table 9.4 is used only to calculate the capital repayment and, if appropriate, the deferred taxation transfers. For the purposes of the balance sheet presentation SSAP 21 requires that the amount due from the lessee should be the net investment (not the net cash investment) in the lease. Thus in the instance of Gasp plc the asset would be recorded as follows:

<i>Balance sheet date</i>	<i>Gross earnings</i>		
	<i>Gross investment</i>	<i>allocated to future periods</i>	<i>Net investment</i>
	£	£	£
31 Dec X0	8000	889	7111
31 Dec X1	6000	(173)	6173
31 Dec X2	4000	(195)	4195
31 Dec X3	2000	(150)	2150
31 Dec X4	–	(52)	52

The gross earnings allocated to future periods are found from line 3 of Table 9.4. Thus, for example, the figure at 31 December 20X0 is £(1062 + 22 – 45 – 98 – 52) = £889 and so on.

The method produces the apparently absurd result that the net investment at certain dates is greater than the remaining lease payments, the extreme case being that at 31 December 20X4 when a net investment of £52 is produced notwithstanding the fact that the lease has terminated. This odd result derives from the fact that a larger profit is taken in the early years of the lease in consequence of the anticipated return on the surplus cash invested; thus, for example, the net investment at 31 December 20X3 of £2150 can be regarded as representing the final lease payment of £2000 plus the anticipated interest receipts of £150 (£98 in 20X4 and £52 in 20X5).

Alternative approaches to accounting for finance leases and hire purchase contracts

As stated on p. 229, Para. 39 of SSAP 21 specifies that in the case of hire purchase contracts gross earnings can be allocated on the basis of the company's net investment. The reason for this is that in the case of hire purchase, capital allowances are granted to the hirer and hence the tax cash flows will not have the same significance to the hire purchase company as they have for a leasing company.

The same paragraph allows, for both hire purchase and leasing contracts, the use of alternative methods that would produce results that would be 'reasonable approximations' to the desired constant rate of return on the net cash investment. A number of alternatives are described in the guidance notes to SSAP 21, which include the investment period method, which is similar to the actuarial method after tax. Other methods described are the Rule of 78 and the actuarial method before tax. These two methods are primarily intended for use with hire purchase contracts but they can be used for finance leases where the amounts concerned are not judged to be material.

Lessors may, if they choose, write off the initial direct costs in arranging a lease over the period on a 'systematic and rational basis'.²⁰ This provision applies to both finance and operating leases.

²⁰ SSAP 21, Para. 44.

Accounting for operating leases by lessors – general principles

The basic principles are contained in Paras 42–44 of SSAP 21. These are:

An asset held for use in operating leases by a lessor should be recorded as a fixed asset and depreciated over its useful life.

Rental income from an operating lease, excluding charges for services such as insurance and maintenance, should be recognized on a straight-line basis over the period of the lease, even if the payments are not made on such a basis, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable.

Initial direct costs incurred by a lessor in arranging a lease may be apportioned over the period of the lease on a systematic and rational basis.

The accounting treatment of operating leases by the lessor is thus straightforward, subject only to the problems of dealing with cases where payment is not received on a straight-line basis and deciding on the circumstances where an alternative systematic and rational basis would be appropriate. These issues are similar to those faced by the lessee (see p. 226).

Disclosure requirements for the lessor in respect of finance and operating leases and hire purchase contracts

The requirements, contained in Paras 58–60 of SSAP 21, are as follows:

- 1 The net investment in (i) finance leases and (ii) hire purchase contracts should be disclosed. Note that separate totals need to be given for leases and hire purchase contracts. In the case of the remaining disclosure requirements, information regarding leases and hire purchase contracts can be combined.
- 2 The gross amount of assets held for use in operating leases and the related accumulated depreciation charge should be disclosed.
- 3 Disclosure should be made of:
 - (a) the policy adopted for accounting for operating leases and finance leases and, in detail, the policy for accounting for finance lease income;
 - (b) the aggregate rentals receivable in respect of an accounting period in relation to (i) finance leases and (ii) operating leases; and
 - (c) the cost of assets acquired, whether by purchase or finance lease, for the purpose of letting under finance leases.

Sale and leaseback transactions

The standard makes specific reference to sale and leaseback transactions that arise when the vendor/lessee sells an asset but continues to have the use of it on the basis of a lease granted by the purchaser/lessor. No problems arise with regard to the treatment of a sale and leaseback transaction in the accounts of the lessor who will record the asset purchased at cost and then, depending on the nature of the lease, follow the provisions of SSAP 21 in the usual way. The position regarding the vendor/lessee is different in so far as there are circumstances where the sales and leaseback transactions will have to be accorded special treatment. The nature of the circumstances depends on the type of lease.

Finance leases

The key characteristic of a finance lease is that the 'risk and reward' associated with the asset rests with the lessee. Hence when a vendor engages in a sale and finance leaseback transac-

tion, the 'risk and reward' is retained. It is therefore argued that in such circumstances it would be wrong to recognise a profit or loss on the sale of the asset concerned in the year in which the sale and leaseback is effected.

Thus SSAP 21 states:

In a sale and leaseback transaction which results in a finance lease, any apparent profit or loss (that is, the difference between the sale price and the previous carrying value) should be deferred and amortized in the financial statements of the seller/lessee over the shorter of the lease term and the useful life of the asset. (Para. 46)

If the asset was sold for its fair value, the above provisions could be avoided by revaluing the asset prior to sale and hence removing any difference between the sale price and the carrying value. However, to the extent that the vendor retains the 'risk and reward' any profit on the sale should not be regarded as being realised, but it would be reasonable to recognise gradually the realisation of any profit over the shorter of the lease term and the useful life of the asset.

If the asset were not sold for its fair value it is likely that the consequence would be that the lease rental payments would be higher (if the asset were sold for more than its fair value) or lower than those which would be charged if the asset had been sold for its fair value. Hence it is reasonable to set the apparent profit or loss against the rental charges.

Operating leases

In the case of an operating lease the 'risks and rewards' are transferred along with the legal title to the asset. Hence any profit or loss on the sale of the asset should be recognised immediately as long as the asset was sold at its fair value.

If the asset is sold for an amount in excess of its fair value, the excess should be written back to the profit and loss account over the shorter of the remainder of the lease term or the period to the next rent review (if any).

Tax-free grants

SSAP 21 was amended in 1997 to cover tax-free grants that may be available to the lessor against the purchase price of assets acquired for leasing. These should be spread over the period of the lease and dealt with by treating the grant as non-taxable income (Para. 41)

Compliance with international standards

IAS 17 *Leases* (revised 1997), defines finance and operating leases in similar terms to SSAP 21 and requires the capitalisation of finance leases by lessees. However, there are differences. One example is that, whereas SSAP 21 makes reference to a figure of 90 per cent for the ratio of the present value of minimum lease payments to fair value in determining whether a finance lease exists, no such figure appears in IAS 17. The international accounting standard takes a more qualitative approach.

Both SSAP 21 and IAS 17 require that a lessor treats a finance lease as a debtor, rather than a fixed asset, in its balance sheet and takes credit for its finance income over the period of the lease. However whereas, as we have explained above, SSAP 21 requires a method based on *net cash investment* in the lease, IAS 17 requires the use of a method based upon the *net investment* in the lease. These different methods for spreading the finance income may give two very different answers.

The two standards also have somewhat different disclosure requirements.

Beyond SSAP 21

Accounting for Leases: A New Approach (1996)

A movement to treat all non-cancellable leases as finance leases has been under way for some time. The opening shot of the international campaign was the publication of a G4+1 Discussion Paper *Accounting for Leases: A New Approach* by the Financial Accounting Standards Board, in 1996. Although the author of the report is stated to be Warren McGregor, the paper is a report of a working party of the G4+1 group of standard setters, made up of representatives of the IASC and groups from five countries.²¹ It confirms that leasing continues to be a major source of financing and suggests that it may become even more important in the future.

The authors of the paper, drawing largely on research carried out in Australia and the USA, conclude that there have been many examples of lease agreements for what are, in all material respects, finance leases that were drawn up in such a way to ensure that they qualified for treatment as operating leases and hence appear 'off the balance sheet'. The authors were sceptical of the ability of standard setters to produce criteria that would overcome this problem. They took a different approach and examined the issue from first principles, largely relying on the definitions of assets and liabilities contained in the IASC's Framework. These are very similar to the ASB definitions that we discussed at some length in Chapters 5 and 7:

An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. (IASC Framework, Para. 49(a))

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (IASC Framework, Para. 49(b))

The report argues that, in respect of any non-cancellable lease, the lessee possesses both an asset and a liability and these should be reflected on its balance sheet. Hence, the report recommends that all non-cancellable leases should be capitalised. This recommendation is advanced on the grounds of both theory and pragmatism. This is normally a powerful combination but it appears to be working slowly in this particular case.

Leases: Implementation of a New Approach (1999)

While SSAP 21 remains in force, the battle continues. In 1999 the ASB published another discussion paper produced by the G4+1 group, *Leases: Implementation of a New Approach*. The 1999 report adopts the same position as its 1996 predecessor but advances the argument in a number of ways.

The cash flows on which the capitalisation is based

The 1999 paper addresses a range of practical issues concerned with the identification of the cash flows that should be capitalised to provide the measure of the initial asset and liability in

²¹ The countries represented were Australia, Canada, New Zealand, the UK and the USA.

the books of the lessee, and covers such issues as possible variations in residual values, the question of contingent rentals and the treatment of long-term property leases.

One of the reasons why SSAP 21 is thought to be inadequate is the rich variety of types of leases that have been developed by the financial community. Many leases are far removed from the simple notion of a predetermined regular flow of resource from lessee to lessor over the life of the agreement. Much of the 1999 paper is concerned with examining the different types of leasing agreement that exist and discussing the basis on which they should be capitalised. We do not have the space to deal with the whole variety of leases discussed in the paper but it would be helpful to quote one as an example, both to provide a flavour of the document and to illustrate the thinking that underpins it.

The example we have selected is of a lease where the rent payable varies according to the revenue generated by the use of the asset. Specifically the example, example 4 in the paper,²² is of an agreement where a lessee enters a three-year lease on a retail store. The annual rent comprises a minimum base rental of 10 000 plus $\frac{1}{2}$ per cent of the store's turnover during that year.

The question is whether the initial value of the lease should be based solely on the present value of the minimum payments, the three annual payments of 10 000, or whether account should be taken of the contingent rental based on turnover.

In this example, the authors came to the view that a fair value approach should be used and an estimate is made of what the rental payments would have been had there not been the turnover element. Suppose that this is 10 500 per annum, then the initial carrying value of the lease should be based on three payments of 10 500 and the differences between those amounts and the amounts actually paid should be credited or debited to the profit and loss account for the relevant year.

In general the approach taken in the paper is to capitalise on the basis of the minimum lease payments and to deal with variations on a year-by-year basis unless, as in the above example, the amount so derived would not provide a reasonable estimate of the fair value of the lease.

The discount rate to be used by the lessee

As we pointed out earlier, SSAP 21 requires the lessee to use the discount rate that it is implied in the leasing agreement and which is set by the lessor, which is not something that the lessee can always readily determine. The 1999 paper takes a much more sensible approach and argues that the discount rate to be applied by lessees should be an estimate of the lessee's incremental borrowing rate for a loan of a similar term and with the same security as is provided by the lease.²³ This proposal underscores the point that a lease is a form of finance and should be treated as far as possible in a comparable way to other sources of finance that the entity might employ.

The recognition of lease-related assets in the books of the lessor

The 1999 paper, unlike the 1996 version, deals with lessors as well as leases. The paper argues that, in the context of a lease agreement, a lessor possesses two distinct assets:

- the right to receive payments from the lessee; and
- the right to the return of the asset at the end of the agreement.

²² *Leases: Implementation of a New Approach*, Para. 4.65.

²³ *Leases: Implementation of a New Approach*, p. 127.

The paper argues that these are distinct assets, one financial and one non-financial, and that they should be reported separately. The paper discusses a number of different ways by which the necessary measurements might be made.

The next step

The ASB asked for comments on the 1999 document with a deadline of 7 April 2000 and other members of the G4+1 group have acted in a similar way. One might by this time have expected some further progress, but it has not come speedily. The ASB position is that, due to the complexities involved and the time it will take to consider them, 'it is unlikely that a Financial Reporting Exposure Draft will be published in the near future'.²⁴ However, the ASB is presently taking the lead in an international project dealing with leases and IAS 17, *Leases*, is on the list of international standards due to be reviewed in 2003, so it now seems that the shelf-life of SSAP 21 is somewhat limited.

Summary

We have in this chapter concerned ourselves with the important topic of substance over form. We first examined the main provisions of FRS 5 and noted that it requires that an entity's financial statements should report on the substance of the transaction into which it has entered and that this essentially depends on whether the entity can recognise an asset or a liability.

We then examined a particularly important example of the concept, the accounting treatment of leases. The importance of the topic was such that the relevant accounting standard, SSAP 21, predated FRS 5 by some ten years. The need for haste in this area was because strict adherence to legal form meant that the balance sheets of many entities significantly understated assets and liabilities, the latter being more critical in entities in poor financial health. The resulting so-called 'off balance sheet financing' was a practice that had to be stopped.

We saw the way in which SSAP 21 sought to outlaw the practice by identifying a group of leases, finance leases, that had to be capitalised thus giving rise to both an asset and a liability in the books of the lessee. We also saw how SSAP 21 impacted on the financial statements of lessors.

We have discussed the criticisms that have been made of SSAP 21, in particular its view that certain types of leases, operating leases, should not be capitalised, and we have introduced two important discussion papers that appear to be taking us in a direction when all non-cancellable leases will be capitalised by the lessee. It now seems likely that the shelf-life of both SSAP 21 and the international standard IAS 17 will be rather short.

Recommended reading

The PricewaterhouseCoopers Leasing Team, *Leasing in the UK*, Tolley, Croydon, 2002.

B.A. Rutherford, *The Doctrine of Substance over Form*, Certified Accountants Publications Limited, London, 1988.

Excellent up-to-date and detailed reading on the subject matter of this chapter and on much of the contents of this book is provided by the most recent edition of:

²⁴ <http://www.asb.org.uk/publications>.

UK and International GAAP, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Ernst & Young, Butterworths Tolley, London. At the time of writing, the latest edition is the 7th, published 2001. See Chapters 18 and 19.

Questions

9.1 The objective of FRS 5 – *Reporting the substance of transactions*, is to ensure that a reporting entity's financial statements report the substance of the transactions into which it has entered.

You are the management accountant of BLFB plc. BLFB plc imports timber which it uses to manufacture and sell a large range of furniture products. BLFB plc makes up financial statements to 30 June each year.

On 1 June 1999, BLFB plc purchased for £40 million a large quantity of timber from an overseas supplier. The timber was intended to be used in the manufacture of a large quantity of high-quality furniture. Before manufacturing such furniture, it is necessary to keep the new timber in controlled conditions for at least five years from the date of purchase.

On 1 July 1999, BLFB plc sold the timber to Southland Bank plc for £45 million. The timber was physically retained by BLFB plc under the controlled conditions that were necessary to render the timber suitable for use. At the date of the sale on 1 July 1999, BLFB plc signed an agreement to re-purchase the timber from Southland Bank plc on 30 June 2004 for a price of £66.12 million. Responsibility for the security and condition of the timber remained with BLFB plc.

Your assistant, who is responsible for preparing the draft financial statements for the year ended 30 June 2000, has shown the transaction as a sale of £45 million and recorded a profit of £5 million.

Requirements

- (a) Write a memorandum to your assistant that:
- (i) describes what is meant by the 'substance' of a transaction and how to determine 'substance'; (5 marks)
 - (ii) explains why FRS 5 requires transactions to be accounted for according to their substance. (5 marks)
- (b) (i) Prepare all the journal entries that should have been made in the financial statements of BLFB plc for the year ended 30 June 2000 in order to account correctly for the sale of timber to Southland Bank plc. (4 marks)
- (ii) Explain fully how the entries you have made comply with the relevant provisions of FRS 5. You should also explain why the treatment suggested by your assistant is incorrect. (6 marks)

CIMA, Financial Reporting, November 2000 (20 marks)

9.2 You are the management accountant of Tree plc, a listed company that prepares consolidated financial statements. Your Managing Director, who is not an accountant, has recently attended a seminar at which key financial reporting issues were discussed. She remembers being told that:

- financial statements of an entity should reflect the substance of its transactions;
- the way to determine the substance of a transaction is to consider its effect on the assets and liabilities of the entity carrying out the transaction.

The year end of Tree plc is 31 August. In the year to 31 August 2001, the company entered into the following transactions:

Transaction 1

On 1 March 2001, Tree plc sold a property to a bank for £5 million. The market value of the property at the date of the sale was £10 million. Tree plc continues to occupy the property rentfree. Tree plc has the option to buy the property back from the bank at the end of every month from 31 March 2001 until 28 February 2006. Tree plc has not yet exercised this option. The repurchase price will be £5 million plus £50,000 for every complete month that has elapsed from the date of sale to the date of repurchase. The bank cannot require Tree plc to repurchase the property and the facility lapses after 28 February 2006. The directors of Tree plc expect property prices to rise at around 5% each year for the foreseeable future.

Transaction 2

On 1 September 2000, Tree plc sold one of its branches to Vehicle Ltd for £8 million. The net assets of the branch in the financial statements of Tree plc immediately before the sale were £7 million. Vehicle Ltd is a subsidiary of a bank and was specifically incorporated to carry out the purchase – it has no other business operations. Vehicle Ltd received the £8 million to finance this project from its parent in the form of a loan.

Tree plc continues to control the operations of the branch and receives an annual operating fee from Vehicle Ltd. The annual fee is the operating profit of the branch for the 12 months to the previous 31 August less the interest payable on the loan taken out by Vehicle Ltd for the 12 months to the previous 31 August. If this amount is negative, then Tree plc must pay the negative amount to Vehicle Ltd.

Any payments to or by Tree plc must be made by 30 September following the end of the relevant period. In the year to 31 August 2001, the branch made an operating profit of £2,000,000. Interest payable by Vehicle Ltd on the loan for this period was £800,000.

Required

- (a) Evaluate the extent to which the advice given to the Managing Director at the seminar is in accordance with generally accepted accounting principles. (4 marks)
- (b) Explain how the transactions described above will be dealt with in the consolidated financial statements (balance sheet and profit and loss account) of Tree plc for the year ended 31 August 2001.

(9 marks are allocated to transaction 1 and 7 marks to transaction 2)
(16 marks)

CIMA, Financial Reporting – UK Accounting Standards, November 2001

(20 marks)

- 9.3** Financial Reporting Standard 5 Reporting the Substance of Transactions requires an entity's financial statements to report the substance of transactions into which it has entered. The FRS sets out how to determine the substance of a transaction and whether any resulting assets and liabilities should be included in the balance sheet. The FRS came about partly as a result of concern over arrangements made by companies whereby assets and liabilities were omitted from the balance sheet.

Required

- (a) Explain the reasons why companies may wish to omit assets and liabilities from their balance sheets. (5 marks)
- (b) Explain the reasons why the Accounting Standards Board felt it necessary to introduce FRS 5 Reporting the Substance of Transactions. (5 marks)
- (c) Discuss the proposed treatment of the following items in the financial statements:
 - (i) Beak plc sells land to a property investment company, Wings plc. The sale price is £20 million and the current market value is £30 million. Beak plc can buy the land back at any time in the next five years for the original selling price plus an annual commission of 1% above the current bank base rate. Wings plc cannot require Beak plc to buy the land back at any time.

The accountant of Beak plc proposes to treat this transaction as a sale in the financial statements. (7 marks)

- (ii) A car manufacturer, Gocar plc, supplies cars to a car dealer, Sparks Ltd, on the following terms. Sparks Ltd has to pay a monthly fee of £100 per car for the privilege of displaying it in its showroom and also is responsible for insuring the cars. When a car is sold to a customer, Sparks Ltd has to pay Gocar plc the factory price of the car when it was first supplied. Sparks Ltd can only return the cars to Gocar plc on the payment of a fixed penalty charge of 10% of the cost of the car. Sparks Ltd has to pay the factory price for the cars if they remain unsold within a four month period. Gocar plc cannot demand the return of the cars from Sparks Ltd.

The accountant of Sparks Ltd proposes to treat the cars unsold for less than four months as the property of Gocar plc and not show them as stock in the financial statements. (8 marks)

ACCA, *Accounting and Audit Practice, December 1994*

(25 marks)

- 9.4** FRS 5 – Reporting the Substance of Transactions – requires that a reporting entity’s financial statements should report the substance of the transactions into which it has entered. FRS 5 states that in order to determine the substance of a transaction it is necessary to identify whether the transaction has given rise to new assets or liabilities for the reporting entity and whether it has changed the entity’s existing assets or liabilities.

You are the management accountant of D Ltd which has three principal activities. These are the sale of motor vehicles (both new and second-hand), the provision of spare parts for motor vehicles and the servicing of motor vehicles.

During the financial year ended 31 August 1996, the company has entered into a type of business transaction not previously undertaken. With effect from 1 January 1996, D Ltd entered into an agreement whereby it received motor vehicles on a consignment basis from E plc, a large manufacturer. The terms of the arrangement were as follows:

- (i) On delivery, the stock of vehicles remains the legal property of E plc.
- (ii) Legal title to a vehicle passes to D Ltd either when D Ltd enters into a binding arrangement to sell the vehicle to a third party or six months after the date of delivery by E plc to D Ltd.
- (iii) At the date legal title passes, E plc invoices D Ltd for the sale of the vehicles. The price payable by D Ltd is the normal selling price of E plc *at the date of delivery*, increased by 1% for every complete month the vehicles are held on consignment by D Ltd. Any change in E plc’s normal selling price between the date of delivery and the date legal title to the goods passes to D Ltd does not change the amount payable by D Ltd to E plc.
- (iv) At any time between the date of delivery and the date legal title passes to D Ltd, the company (D Ltd) has the right to return the vehicles to E plc *provided they are not damaged or obsolete*. D Ltd does not have the right to return damaged or obsolete vehicles. If D Ltd exercises this right of return then a return penalty is payable by D Ltd as follows:

<i>Time since date of delivery</i>	<i>Penalty as a percentage of invoiced price*</i>
Three months or less	50%
Three to four months	75%
More than four months	100%

* i.e. the price that would otherwise be payable by D Ltd if legal title to the vehicles had passed at the date of return.

- (v) E plc has *no right to demand* return of vehicles on consignment to D Ltd unless D Ltd becomes insolvent.

The managing director suggests that the vehicles should be shown as an asset of D Ltd only when title passes, and the purchase price becomes legally payable.

Requirement

Write a report to the managing director which:

- (a) explains how (under the principles established in FRS 5) an asset or liability is identified, and when an asset or liability should be recognised and should cease to be recognised, in the financial statements of a business; (12 marks)
- (b) evaluates, in the light of the principles you have explained in (a), the correctness, or otherwise, of the managing director's suggested accounting treatment for the new transaction. (8 marks)

CIMA, Financial Reporting, November 1996 (20 marks)

- 9.5** FRS 5 – *Reporting the Substance of Transactions* – requires that a reporting entity's financial statements should report the substance of the transactions into which it has entered.

You are the management accountant of S Ltd. During the most recent financial year (ended 31 August 1998), the company has entered into a debt factoring arrangement with F plc. The main terms of the agreement are as follows:

- 1 On the first day of every month S Ltd transfers (by assignment) all its trade debts to F plc, subject to credit approval by F plc for each debt transferred by S Ltd.
- 2 At the time of transfer of the debtors to F plc, S Ltd receives a payment from F plc of 70% of the gross amount of the transferred debts. The payment is debited by F plc to a factoring account which is maintained in the books of F plc.
- 3 Following transfer of the debts, F plc collects payments from debtors and performs any necessary follow-up work.
- 4 After collection by F plc, the cash received from the debtor is credited to the factoring account in the books of F plc.
- 5 F plc handles all aspects of the collection of the debts of S Ltd in return for a monthly charge of 1% of the total value of the debts transferred at the beginning of that month. The amount is debited to the factoring account in the books of F plc.
- 6 Any debts not collected by F plc within 90 days of transfer are regarded as bad debts by F plc and re-assigned to S Ltd. The cash previously advanced by F plc in respect of bad debts is recovered from S Ltd. The recovery is only possible out of the proceeds of other debtors which have been assigned to S Ltd. For example, if, in a particular month, S Ltd assigned trade debts having a value of £10 000 and a debt of £500 was identified as bad, then the amounts advanced by F plc to S Ltd would be £6650 [$70\% \times £10\,000 - 70\% \times £500$].
- 7 On a monthly basis, F plc debits the factoring account with an interest charge which is calculated on a daily basis on the balance on the factoring account.
- 8 At the end of every quarter, F plc pays over to S Ltd a sum representing any credit balance on its factoring account with S Ltd at that time.

Requirement

Write a memorandum to the Board of Directors of S Ltd which outlines:

- (a) how, under the principles set out in FRS 5, the substance of a transaction should be determined; (10 marks)
- (b) how the debt factoring arrangement will be reported in the financial statements of S Ltd. (10 marks)

CIMA, Financial Reporting, November 1998 (20 marks)

- 9.6** You are the management accountant of Prompt plc, a UK company which prepares financial statements to 31 March each year. The financial statements for the year ended 31 March 1998 are due to be formally approved by the board of directors on 15 June 1998.

Your assistant has prepared a first draft of the financial statements. These show a turnover of £200 million and a profit before taxation of £18 million. Your assistant has identified a number of transactions [(a), (b) and (c) in Requirement, below] for which he is unsure of the correct accounting treatment. For each transaction, he has indicated the treatment followed in the draft financial statements. You have reviewed the transactions highlighted by your assistant.

Requirement

Draft a memorandum to your assistant which explains the correct accounting treatment for each transaction. Where the treatment adopted by your assistant in the draft financial statements is incorrect, your memorandum should indicate the reasons for this. For each transaction, your memorandum should refer to relevant provisions of company law and Accounting Standards.

Transaction (a)

During the year ended 31 March 1998, Prompt plc entered into an arrangement with a finance company to factor its debts. Each month 90% of the value of the debts arising from credit sales that month was sold to the factor, who assumed legal title and responsibility for collection of all debts. Upon receipt of the cash by the factor, the remaining 10% was paid to Prompt plc less a deduction for administration and finance costs. Any debtor who did not pay the factor within three months of the debt being factored was transferred back to Prompt plc and the amounts advanced by the factor recovered from Prompt plc. In preparing the draft financial statements, your assistant has removed the whole of the factored debts from trade debtors at the date the debts are factored. The net amount receivable from the factor has been shown as a sundry debtor. (5 marks)

Transaction (b)

On 15 March 1998, Prompt plc decided to close one of its three factories. This decision was taken because the product (called product X) which was manufactured at the factory was considered obsolete. A gradual run down of the operation commenced on 15 April 1998 and was expected to be complete by 15 June 1998. The factory produced monthly operating statements detailing turnover, profits and assets, and the turnover for the year ended 31 March 1998 was £35 million. Closure costs (including redundancy) were estimated to be £2.5 million. Your assistant has made no entries in the draft financial statements in respect of the closure since it took place in the year ending 31 March 1999. (12 marks)

Transaction (c)

On 30 June 1997, Prompt plc issued 100 million £1 debentures. The issue costs were £100 000. The debentures carry no interest entitlement but are redeemable on 30 June 2007 at a price of £259 million. Your assistant has included the nominal value of the debentures (£100 million) as part of shareholders' funds since they represent long-term finance for the company. The issue costs of £100 000 have been charged to the profit and loss account for the year, and your assistant suggests that the difference between the issue price and the redemption price should be dealt with in 2007 when the debentures are redeemed. (8 marks)

CIMA, Financial Reporting, May 1998

(25 marks)

- 9.7** S plc is a large manufacturing company. The company needs to purchase a major piece of equipment which is vital to the production process. S plc does not have sufficient cash available to buy this equipment. It cannot raise the necessary finance by issuing shares because it would not be cost-effective to have a share issue for the amount involved. The directors are

also unwilling to borrow because the company already has a very high level of debt in its balance sheet.

C Bank has offered to lease the equipment to S plc. The bank has proposed a finance package in which S plc would take the equipment on a two-year lease. The intention is that S plc will take out a second two-year lease at the conclusion of the initial period and a third at the conclusion of that one. By that time the equipment will have reached the end of its useful life.

C Bank will not require S plc to commit itself in writing to the two secondary lease periods. Instead, S plc will agree in writing to refurbish the equipment to a brand new condition before returning it to C Bank. This condition will, however, be waived if the lease is subsequently extended to a total of six years or more. Once the equipment is used, it would be prohibitively expensive to refurbish it.

S plc's directors are very interested in the arrangement proposed by C Bank. They believe that each of the two-year contracts could be accounted for as an operating lease because each covers only a fraction of the equipment's expected useful life.

Required

- (a) Explain how the decision to treat the lease as an operating lease rather than a finance lease would affect S plc's profit and loss account, balance sheet and any accounting ratios based on these. (6 marks)
- (b) Explain whether S plc should account for the proposed lease as an operating lease or as a finance lease. (4 marks)
- (c) The relationship between debt and equity in a company's balance sheet is often referred to as the gearing ratio. Explain why companies are often keen to minimise the gearing ratio. (5 marks)
- (d) It has been suggested that the rules governing the preparation of financial statements leave some scope for the preparers of financial statements to influence the profit figure or balance sheet position. Explain whether you agree with this suggestion. (5 marks)

CIMA, Financial Accounting – UK Accounting Standards, May 2001 (20 marks)

- 9.8** You are the financial director of Pilgrim plc, a listed company. Your new group managing director, appointed from one of Pilgrim plc's overseas subsidiaries, is reviewing the principal accounting policies and is having difficulty understanding the accounting treatment and disclosure of assets leased by Pilgrim plc as lessee, of which there are a substantial number (both finance and operating leases).

Requirement

Prepare a memorandum for your managing director explaining, in simple terms, the basics of accounting for leased assets in the accounts of listed companies (in full compliance with the relevant accounting standards and the Companies Acts). Your memorandum should be set out in sections as follows:

- (a) Outline the factors which can influence the decision as to whether a particular lease is a finance lease or an operating lease. (4 marks)
- (b) As an example, taking the following non-cancellable lease details:
 - fair value (as defined in SSAP 21): £100 000
 - lease payments: five annual payments in advance of £20 000 each
 - estimated residual value at the end of the lease: £26 750 of which £15 000 is guaranteed by Pilgrim plc as lessee
 - interest rate implicit in the lease: 10%

demonstrate whether the lease falls to be considered as a finance lease or an operating lease under the provisions of SSAP 21, explaining the steps in reaching a conclusion.

(4 marks)

- (c) Explain briefly any circumstances in which a lessor and a lessee might classify a particular lease differently, i.e. the lessee might classify a lease as an operating lease whilst the lessor classifies the same lease as a finance lease or vice versa. (3 marks)
- (d) Explain briefly any circumstances in which the requirements of SSAP 21 with regard to accounting for operating leases by lessees might result in charges to the profit and loss account different from the amounts payable for the period under the terms of a lease. (3 marks)
- (e) Draft a concise accounting policy in respect of 'Leasing' (as a lessee only) suitable for inclusion in the published accounts of Pilgrim plc and comment on the key aspects of your policy to aid your managing director's understanding. (4 marks)
- (f) List the other disclosures Pilgrim plc is required to give in its published accounts in respect of its financial transactions as a lessee. (3 marks)

Note: Ignore taxation.

ICAEW, *Financial Accounting 2, December 1992* (21 marks)

- 9.9** Flow Ltd prepares financial statements to 31 March each year. On 1 April 1998, Flow Ltd sold a freehold property to another company, River plc. Flow Ltd had purchased the property for £500 000 on 1 April 1988 and had charged total depreciation of £60 000 on the property for the period 1 April 1988 to 31 March 1998.

River plc paid £850 000 for the property on 1 April 1998, at which date its true market value was £550 000.

From 1 April 1998 the property was leased back by Flow Ltd on a ten-year operating lease for annual rentals (payable in arrears) of £100 000. A normal annual rental for such a property would have been £50 000.

River plc is a financial institution which, on 1 April 1998, charged interest of 10.56% per annum on ten-year fixed rate loans.

Requirements

- (a) Explain what is meant by the terms 'finance lease' and 'operating lease' and how operating leases should be accounted for in the financial statements of lessee companies. (7 marks)
- (b) Show the journal entries which Flow Ltd will make to record:
- its sale of the property to River plc on 1 April 1998,
 - the payment of the first rental to River plc on 31 March 1999.

Justify your answer with reference to appropriate Accounting Standards. (13 marks)

CIMA, *Financial Reporting, May 1999* (20 marks)

- 9.10** Leese, a public limited company and a subsidiary of an American holding company operates its business in the services sector. It currently uses operating leases to partly finance its usage of land and buildings and motor vehicles. The following abbreviated financial information was produced as at 30 November 2000:

Profit and Loss Account for the year ending 30 November 2000

Turnover	£m 580
Profit on ordinary activities before taxation	88
Taxation on profit on ordinary activities	(30)
Profit on ordinary activities after taxation	<u>58</u>

Balance Sheet as at 30 November 2000

Fixed assets	200
Net current assets	170
Creditors: amounts falling due after more than one year (interest free loan from holding company)	(50)
	<u>320</u>
Share Capital	200
Profit and Loss Account	<u>120</u>
	<u>320</u>

Notes

Operating lease rentals for the year – paid 30 November 2000:

	£m
Land and buildings	30
Motor vehicles	10

Future minimum operating lease payments for leases payable on 30 November each year were as follows:

Year	Land and Buildings	Motor Vehicles
	£m	£m
30 November 2001	28	9
30 November 2002	25	8
30 November 2003	20	7
Thereafter	<u>500</u>	<u>—</u>
Total future minimum operating lease payments (non-cancellable)	<u>573</u>	<u>24</u>

The company is concerned about the potential impact of bringing operating leases onto the balance sheet on its profitability and its key financial ratios. The directors have heard that the Accounting Standards Board (ASB) is moving towards this stance and wishes to seek advice on the implications for the company.

For the purpose of determining the impact of the ASB's proposal, the directors have decided to value current year and future operating lease rentals at their present value.

The appropriate interest rate for discounting cash flows to present value is 5% and the current average remaining lease life for operating lease rentals after 30 November 2003 is deemed to be 10 years.

Depreciation on land and buildings is 5% per annum and on motor vehicles is 25% per annum with a full year's charge in the year of acquisition. The rate of corporation tax is 30% and depreciation rates equate to those of capital allowances. Assume that the operating lease agreements commenced on 30 November 2000.

Required

- (a) Discuss the reasons why accounting standard setters are proposing to bring operating leases onto the balance sheets of companies. (7 marks)
- (b) (i) Show the effect on the Profit and Loss Account for the year ending 30 November 2000 and the Balance Sheet as at 30 November 2000 of Leese capitalising its operating leases; (10 marks)
- (ii) Discuss the specific impact on key performance ratios as well as the general business impact of Leese capitalising its operating leases. (8 marks)

9.11 Accounting for leases has been a problematical issue for some years. In 1984, SSAP 21, – *Leases and hire purchase contracts* was issued. This Accounting Standard requires that lessee companies capitalise leased assets in certain circumstances. The Standard classifies leases as either finance leases or operating leases, depending on the terms of the lease. In December 1999, the Accounting Standards Board (ASB) published a Discussion Paper – *Leases: Implementation of a New Approach*.

Under the recommended approach, at the beginning of a lease the lessee would recognise an asset and a liability equivalent to the fair value of the rights and obligations that are conveyed by the lease (usually the present value of the minimum payments required by the lease); thereafter, the accounting for the leased asset and liability would follow the normal requirements for accounting for fixed assets and debt.

Expo plc prepares financial statements to 30 September each year. On 1 October 2001, Expo plc leased a fleet of cars for its sales force. There were 50 identical cars in the fleet. Relevant details for each car are as follows:

- Fair value on 1 October 2001 was £10000.
- Lease term is 2 years.
- Estimated residual value of car on 30 September 2003 is £3000.
- Lease rentals are £9000 in total – a payment of £4000 on 1 October 2001 plus two payments of £2500 on 30 September 2002 and 30 September 2003.
- The payments of £2500 increase by £1 for every mile travelled in excess of an agreed annual maximum of 50000 miles per car.
- The lessor is responsible for repair and maintenance of the fleet.

Required

- (a) Explain the factors that led to the issue of the Discussion Paper in 1999. (6 marks)
- (b) Demonstrate the effect of the leasing arrangement on the profit and loss account of Expo plc for the year ended 30 September 2002 and its balance sheet at 30 September 2002,
- assuming Expo plc follows SSAP 21; (7 marks)
 - assuming Expo plc follows the proposals outlined in the Discussion Paper. (7 marks)

Note: The discount rate to be used where relevant is 10%. In requirement (b), you should explain exactly where in the profit and loss account and balance sheet the relevant amounts will be reported.

CIMA, *Financial Reporting – UK Accounting Standards, November 2002* (20 marks)