

IAS 17 Leases

Overview

IAS 17 sets out the required accounting treatments and disclosures for finance and operating leases by both lessors and lessees, except where IAS 40 is applied to investment property held by a lessee.

Definitions

A finance lease – a lease that transfers substantially all the risks and reward of ownership.

An operating lease – any lease that is not a finance lease.

The lease term – the minimum period for which the lessee has contracted to lease the asset, plus any further period over which the lessee has the option to extend the contract and, at inception of the lease, it is reasonably certain it will do so.

The minimum lease payments – the payments the lessee is contracted to pay (excluding contingent rents, service costs and taxes) plus:

- for a lessee, any amounts guaranteed by the lessee or its related parties and the exercise price of any option where exercise is reasonably certain at inception; and,
- for a lessor, any guaranteed residual value.

The gross investment in the lease – the minimum lease payments plus any unguaranteed residual value.

The net investment in the lease – the present value of the gross investment in the lease when discounted at the interest rate implicit in the lease.

Substance of lease

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that may indicate that a lease should be classified as a finance lease include:
 - ownership of the asset transfer to the lessee at the end of the lease term;
 - the lease term covers substantially all of the asset's economic life;
 - the lessee will have the option to purchase the asset outright at below expected fair value or extend the lease term at below market rent; and
 - the present value of the minimum lease payments amounts to substantially all of the fair value of the asset.
- When a lease includes both land and buildings elements, each element should be assessed and classified separately as a finance or an operating lease. In making this assessment an important consideration is that land normally has an indefinite economic life. (NB Prior to years commencing on or after 1 January 2010 there was a presumption that leases of land in such situations would normally be operating leases.)

Finance leases in the financial statements of lessees

- At inception, finance leases should be recognised as assets and liabilities at the lower of the fair value of the leased property and the present value of the minimum lease payments, as determined at that date.
- Any initial direct costs of the lessee are added to the amount recognised as an asset.
- Minimum lease payments must be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge each period is calculated using a constant interest rate (usually the interest rate implicit in the lease), applied to the outstanding balance. Any contingent rents are charged to profit or loss as incurred.

Operating leases in the financial statements of lessees

- Operating lease payments must be recognised as expenses on a straight-line basis over the lease term, unless another systematic basis better represents the timing of benefits.

Finance leases in the financial statements of lessors

- Lessors should recognise assets held under a finance lease, presented as a receivable at an amount equal to the net investment in the lease.
- The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.
- Manufacturer or dealer lessors should recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales. If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.

Operating leases in the financial statements of lessors

- Lessors should present assets subject to operating leases in their statement of financial position according to the nature of the asset. Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis better represents the time pattern in which the economic benefits in the leased asset diminish.

Sale and leaseback transactions

- The sale of an asset and its subsequent leasing by the former owner should be accounted for in a manner reflecting the substance of the transactions when seen as a package. The actual accounting treatment will depend upon the type of lease involved.
- If a sale and leaseback transaction results in:
 - a finance lease, any excess of sales proceeds over the carrying amount should be deferred and amortised over the lease term.
 - an operating lease and is established at fair value, any profit or loss should be recognised immediately.

Interpretations

SIC 15 *Operating leases – incentives* clarifies that incentives such as rent free periods should be recognised as a reduction of rental income and expense by the lessor and the lessee over the lease term.

SIC 27 *Evaluating the substance of transactions involving the legal form of a lease* clarifies that a series of transactions that involve the legal form of a lease should be accounted for as a single transaction if the overall economic effect can only be understood with reference to the series as a whole.

IFRIC 4 *Determining whether an arrangement contains a lease* clarifies that arrangements that depend on the use of a specific asset or convey the right to control a specific asset are generally leases under IAS 17.

IFRIC 12 *Service concession arrangements* sets out accounting principles to be applied by operators in public-to-private service concession arrangements covering, *inter alia*, the recognition of the infrastructure assets to which the service concession arrangement relates. SIC 29 sets out additional disclosure requirements in respect of such arrangements.