

TREASURER'S DIRECTIONS

ACCOUNTING – LIABILITIES

Section A3.6 : Leases

STATEMENT OF INTENT

Assets required by Agencies to deliver outputs can be obtained by purchase or by lease. This Section provides the minimum control requirements relating to the recognition, management and recording of operating and finance leases.

MAIN FEATURES

Section 38 of the *Financial Management Act* requires every Accountable Officer and every employee of an Agency to comply with the Treasurer's Directions.

Leases

- A lease is an agreement conveying the right from a lessor to a lessee to use an asset for a stated period of time in return for payment by the lessee to the lessor.

The Buy or Lease Decision

- An Agency is to consider the costs and rewards of buying an asset versus the costs and rewards of leasing an asset when deciding the most appropriate means of obtaining the use of an asset.

Types of Leases

- Each lease is to be classified as either an operating or finance lease.

Agency as Lessee under a Finance Lease

- Approval under the *Financial Management Act* is required before entering into a finance lease.
- At the beginning of a finance lease an asset and liability equal to the present value of the minimum lease payments is to be recognised.
- Lease payments are to be apportioned between interest expense and a reduction of the lease liability.

Agency as Lessee under an Operating Lease

- Lease payments under an operating lease are to be recognised as expenses.

Management of Leased Assets

- Leased assets are to be subject to appropriate management, accountability and control arrangements.

For authoritative instruction and guidance, reference should be made to related Treasurer's Directions and associated commentary, relevant Australian Accounting Standards and Urgent Issues Group Interpretations.

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AUTHORITIES Financial Management Act

REFERENCES

AASB 101	Presentation of Financial Statements
AASB 117	Leases
AASB 140	Investment Properties
UIG 115	Operating Leases - Incentives
UIG 127	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
	Agency Financial Management Principles

Related Treasurer's Directions:

A2.1	Accounting – Assets : Overview
A2.2	Accounting – Assets : Property, Plant and Equipment
A2.3	Accounting – Assets : Depreciation
A2.4	Accounting – Assets : Revaluation
A2.9	Accounting – Assets : Prepayments
A3.1	Accounting – Liabilities : Overview
A3.2	Accounting – Liabilities : Accounts Payable and Accrued Expenses

WHAT ARE LEASES ?

A3.6.1

Leases are agreements that convey the right from a lessor to a lessee to use an asset for a stated period of time in return for payment by the lessee to the lessor.

- (i) Under a lease agreement, the lessor is the legal owner of the asset and gives the lessee the right to use that asset in return for a series of payments. A lease agreement includes contracts of hire and agreements where the lessee has an option to acquire title to the asset upon fulfilment of agreed conditions (such as a hire purchase agreement).
- (ii) Property, plant and equipment assets may be subject to lease arrangements including:
 - land;
 - buildings;
 - infrastructure;
 - motor vehicles;
 - computer equipment; and
 - other equipment (for example, specialised medical equipment).
- (iii) An agreement or contract may relate solely to the leasing of an asset or the leasing of an asset may be one element in a broader set of arrangements. For example, where an Agency enters into an agreement to build, own, operate and/or transfer assets or an Agency agrees to sell an asset and lease it back. Where an agreement contains an identifiable lease, these Treasurer's Directions and AASB 117 provide instruction and guidance on recognising and recording that lease.
- (iv) These Treasurer's Directions and AASB 117 do not apply to lease agreements for
 - exploration for or use of natural resources, such as minerals, oil, gas, and similar resources;
 - license agreements for items such as mineral rights, motion picture films, manuscripts, patents and copyrights.
- (v) This Treasurer's Directions Section does not specifically deal with accounting for public private partnerships. These types of arrangements have the potential to raise complex accounting issues that need to be addressed on an individual basis.

THE BUY OR LEASE DECISION

A3.6.2

An Agency is to consider the costs and rewards of buying an asset versus the costs and rewards of leasing an asset when deciding the most appropriate means of obtaining the use of an asset.

- (i) When an Agency decides that it needs the use of an asset to produce goods and services, it can acquire the use of that asset by:
 - buying the asset; or
 - leasing the asset.
- (ii) The choice between these alternatives is commonly referred to as the 'buy versus lease decision'. In general terms, the buy versus lease decision will entail the comparison of alternatives for purchasing the asset outright with the available leasing options. While the most cost effective alternative is preferred, non-financial factors such as obsolescence and the ability to transfer risk to an external party will need to be considered as part of the buy versus lease decision.
- (iii) Taking into consideration the relative value of the asset being purchased/leased, each Agency should as a minimum, consider the following when assessing the buy versus lease decision:
 - the total cost to Government over the life of the asset, taking into account such things as lease/purchase costs, installation or disposal costs and future costs (at present value);
 - a direct comparison of the Territory's average cost of borrowing versus the cost of financing (interest rate implicit in the lease) from the external entity;
 - an assessment of other risks and rewards either to or from the Agency or the Territory; and
 - other asset or lease specific factors that are relevant to the decision.
- (iv) When deciding to lease an asset, an Agency should have reference to these and related Treasurer's Directions, procurement requirements and other applicable Government policy.

TYPES OF LEASES

A3.6.3

A lease is to be classified either as:

- a finance lease, where substantially all the risks and rewards incidental to ownership of a leased asset are transferred to the lessee; or
- an operating lease, where substantially all the risks and rewards incidental to ownership of a leased asset remains with the lessor.

- (i) Lease classification is made at the inception of the lease. The classification of a lease depends upon the economic substance of the transaction, determined by an analysis of the distribution of risks and rewards incidental to ownership of the leased asset. The type of lease determines the appropriate accounting treatment.
- (ii) The risks of ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset. Rewards of ownership include those obtainable from the use of the asset and gains in realisable value of the asset.
- (iii) An operating lease is a lease under which the lessor effectively retains substantially all the risks and rewards of ownership of the leased asset. That is, the lessor behaves as the owner of the asset. Examples of operating leases include the renting of office premises, hire of equipment and short term licences to occupy Crown land.
- (iv) A finance lease is a lease under which the risks and rewards normally associated with ownership of an asset are transferred to the lessee, while legal ownership remains with the lessor. Under a finance lease the lessee is more like the owner of the asset and the lease is a means of financing what is effectively a purchase of an asset. For example, when leasing specialised laboratory equipment under a finance lease, an Agency would be expected to incur many of the costs associated with ownership, such as repairs and maintenance, improvements and disposal.

Section A3.6 : Liabilities – Leases

- (v) In undertaking an assessment of the substance of the lease arrangement, the following situations either individually or in combination would normally lead to a lease being classified as a finance lease:
- the lease transfers ownership of the asset to the lessee by the end of the lease term;
 - the lease term is for a major part of the economic life of the asset even if the title is not transferred;
 - at the inception of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset (the discount rate to be used in applying this test is the interest rate implicit in the lease);
 - the leased assets are of such a specialised nature that only the lessee can use them without major modification; and
 - the lease is non-cancellable.
- (vi) A non-cancellable lease means a lease which:
- can be cancelled only with the permission of the lessor (legal owner of the leased asset) or upon the occurrence of some remote contingency;
 - provides that the lessee, upon cancellation, incurs a penalty of a magnitude that is expected to discourage cancellation in normal circumstances; or
 - the lessee, upon cancellation, is committed to enter into a further lease for the same or equivalent asset with the same lessor or a third party related to the lessor.
- (vii) Urgent Issues Group (UIG) Interpretation 127 provides further instruction and guidance in relation to evaluating the substance of transactions involving the legal form of a lease.

AGENCY AS LESSEE UNDER A FINANCE LEASE

A3.6.4

Approval under the *Financial Management Act* is required prior to an Agency, as lessee, entering into a finance lease.

- (i) Entering into a finance lease, as lessee, is a form of borrowing and requires the approval of the Treasurer (or delegate) under Section 32 of the *Financial Management Act* that specifies borrowing requirements.
- (ii) Under a finance lease the lessee has acquired the right to most of the risks and rewards associated with the use of the leased asset. In return for that right, the lessee enters into an obligation to make periodic payments which in total approximate the fair value of the leased asset, and related fees and finance charges. A finance lease is in effect a way of financing the purchase of an asset.

A3.6.5

At the inception of a finance lease, an Agency is to recognise an asset and a liability equal to the fair value of the leased asset or the present value of the minimum lease payments, which ever is the lower amount.

- (i) An asset or liability is recognised when an amount is recorded in an Agency's Balance Sheet. Treasurer's Directions Sections A2.1 and A3.1 provide further instruction and guidance on the recognition of assets and liabilities.
- (ii) A finance lease arrangement is recognised by recording an asset and a liability in the Balance Sheet equal to the fair value of the leased assets or the present value of the minimum lease payments, which ever is the lowest.
- (iii) The minimum lease payments are the rental payments over the term of the lease, including any initial direct costs, purchase option, premium and guaranteed residual value.
- (iv) Minimum lease payments do not include contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor. AASB 117 provides further instruction and guidance in relation to contingent rentals.
- (v) In calculating the present value of the minimum lease payments, the applicable discount rate is the interest rate implicit in the lease. The interest rate implicit in the lease is the interest rate that equates the present value of the minimum lease payments with the fair value of the leased asset at the inception of the lease. Many lease agreements will explicitly identify the implicit interest rate in the lease. Where the interest rate implicit in the lease is not known or is impracticable to determine, then the rate equal to the Territory's long term average cost of borrowing may be applied.

Section A3.6 : Liabilities – Leases

- (vi) Treasurer's Directions Section A2.2 establishes a \$10,000 capitalisation threshold for property, plant and equipment assets. In situations where the present value of the minimum lease payments is below the capitalisation threshold, the lease may be accounted for as an operating lease. Consequently, no asset or liability is recorded and the minimum lease payments are treated as an expense.
- (vii) A property, plant and equipment asset recognised under a finance lease and reported in the Balance Sheet is subject to the requirements of the Treasurer's Directions relating to assets. In particular, Treasurer's Direction Sections A2.1 and 2.2 provide further instruction and guidance in relation to assets and items of property, plant and equipment.

A3.6.6

Agency assets recognised under a finance lease are to be depreciated.

- (i) Where there is reasonable assurance at the inception of the lease that the Agency will obtain ownership of the asset at the end of the lease term, the asset is depreciated over its useful life. However, if there is no reasonable assurance that ownership of the asset will be obtained, the asset is depreciated over the term of the lease.
- (ii) Treasurer's Directions Section A2.3 provides further instruction and guidance in relation to the depreciation of assets, in particular the expected useful lives for non-current assets.

A3.6.7

An Agency is to apportion each lease payment between interest expense and a reduction of the outstanding lease liability.

- (i) The amount of interest expense for a period is determined by applying the interest rate used to discount the minimum lease payments (the interest rate implicit in the lease) to the outstanding lease liability. The balance of the lease payment for that period is treated as a repayment of the principal of the lease liability.
- (ii) Refer to [Appendix A](#) for an example of the accounting treatment where an Agency is the lessee under a finance lease.

AGENCY AS LESSEE UNDER AN OPERATING LEASE

A3.6.8 An Agency, as lessee under an operating lease, is to recognise minimum lease payments as an expense in the Operating Statement.

A3.6.9 Agency lease expenses are to be recognised on a straight line basis over the term of the lease, unless another systematic basis is more representative.

- (i) In most situations, lease payments are made at regular intervals throughout the term of the lease, consequently, the lease expenses would be recognised at the time the lease payments are due (straight line basis).
- (ii) While Agencies are encouraged to recognise expenses on a straight line basis, Agencies may apply another systematic method which better reflects the consumption of economic benefits. The application of another systematic method may result in the lease expense being prepaid or accrued, depending on the circumstances. Treasurer's Directions Sections A2.9 and A3.2 provide further instruction and guidance in relation to prepayments and accrued expenses.
- (iii) Refer to Appendix B for an example of the accounting treatment where an Agency is the lessee under an operating lease.
- (iv) Agencies may be offered an incentive to enter into a lease such as a rent free period or payment for fit-out costs, by the lessor. Agencies should remain aware of the administrative cost of recognising lease incentives and should only consider recognition of material incentives. Urgent Issues Group (UIG) Interpretation 115 provides further instruction and guidance in respect to the recognition of incentives in operating leases.

AGENCY AS LESSOR UNDER A FINANCE LEASE

A3.6.10 The Treasurer's approval is required under the *Financial Management Act* prior to an Agency, as lessor, entering into a finance lease.

- (i) Entering into a finance lease, as lessor, is a form of lending and requires the approval of the Treasurer under Section 31 of the *Financial Management Act*. Situations in which an Agency would be the lessor under a finance lease are rare.
- (ii) Under a finance lease the lessor has transferred the right to most of the risks and rewards incidental to the use of the leased asset. In return for that right, the lessee enters into an obligation to make periodic payments which in total approximate the fair value of the leased asset, and related fees and finance charges. The lessor is in effect providing finance for the purchase of an asset by the lessee.

Section A3.6 : Liabilities – Leases

- (iii) Any decision by an Agency to lease assets to other entities under a finance lease arrangement should be made in the best interests of the Territory after consideration of the following:
- whether a lease arrangement is the most efficient utilisation of that asset where an asset is not required to produce outputs;
 - that the leasing of assets is not generally part of an Agency's core business (requires additional resources and specialist skills); and
 - the full implications of lending (for example, risk of non payment).
- (vi) AASB 117 provides further instruction and guidance in relation to accounting for a finance lease where an Agency is the lessor.

AGENCY AS LESSOR UNDER AN OPERATING LEASE

A3.6.11 An Agency, as a lessor under an operating lease, is to recognise the minimum lease payments as income in the Operating Statement.

A3.6.12 Agency lease income is to be recognised on a straight line basis over the term of the lease, unless another systematic basis is more representative.

- (i) Situations in which an Agency would be the lessor under an operating lease are rare and are not generally part of the core business of an Agency. An exception would be the short term lease of certain parcels of land by the Department of Lands and Planning. Any decision by an Agency to lease assets to other entities under an operating lease arrangement should consider whether a lease arrangement is the most efficient use of assets not required to produce outputs.
- (ii) In most situations, lease payments are received at regular intervals throughout the term of the lease, on a straight line basis. Consequently, lease income would be recognised at the time the lease payments are due.
- (iii) Treasurer's Direction Section A2.2 provides additional instruction and guidance in respect to the loan or hire of property, plant and equipment.
- (iv) Where Agencies do lease out items of property, plant and equipment, it would be unusual for lease incentives to be offered. Urgent Issues Group (UIG) Interpretation 115 provides further instruction and guidance in respect to the recognition of incentives in an operating leases

A3.6.13

An Agency, as lessor under an operating lease, is to continue to recognise and classify the asset subject to the lease in the Balance Sheet as a non-current asset.

- (i) Agency property, plant and equipment assets will be recorded as non-current assets and depreciated. Treasurer's Directions Sections A2.2 and A2.3 provide further instruction and guidance.

MANAGEMENT OF LEASED ASSETS

A3.6.14

Leased assets are to be subject to appropriate management, accountability and control arrangements.

A3.6.15

Each Agency is to maintain a Register of Leased Assets for all leased assets that contains the information required for financial reporting purposes.

- (i) Assets, including leased assets, play a key role in the delivery of Agency outputs and as items of 'public property', all leased assets should be subject to appropriate management, accountability and control arrangements.
- (ii) Each Agency should consider the following in the development of management, accountability and control arrangements of leased assets:
- full accountability for newly leased assets, renewals and cessation of lease.
 - safeguarding and protection of assets against loss or damage;
 - monitoring of asset condition, use and performance; and
 - asset life cycle management, taking into account asset planning, acquisition, operation (including maintenance) and disposal.
- (iii) An Agency is required to maintain adequate records in respect of each leased asset under a finance or operating lease. This information will assist the Agency in managing the lease, accounting for the leased asset and meeting financial reporting requirements.

Section A3.6 : Liabilities – Leases

- (iv) The following information would be required to be recorded in Register(s) of Leased Assets:
- description of the leased asset (and key components where appropriate);
 - manufacturer's identification numbers (eg serial number);
 - location;
 - type of lease;
 - date of lease commencement and lease cessation;
 - location of lease agreement and/or other documentation;
 - details in respect of any sub-leases; and
 - other relevant information.
- (v) In addition to the above, for property, plant and equipment under a finance lease, the information required to be recorded by Treasurer's Directions Section A2.2 in the Register of Assets, is also required.

AGENCY AS LESSEE UNDER A FINANCE LEASE – EXAMPLE

An Agency, having obtained the Treasurer's approval, enters into a lease for a photocopier on the following terms:

Lease payments payable annually	\$6,427
Net present value of minimum lease payments (at implicit interest rate of 9 per cent)	\$25,000
Fair value	\$25,000
Lease term	5 years
Guaranteed residual value	Nil
Useful life of asset (no scrap value)	5 years

The above lease would be classified as a finance lease because an analysis of its substance shows that substantially all the risks and rewards incidental to ownership of the photocopier would pass to the Agency.

This determination is supported by the indicative criteria that:

- the lease is non-cancellable;
- the lease term is equal to the expected useful life of the photocopier; and
- the present value of the minimum lease payments is equal to the fair value of the photocopier at the start of the lease.

Below is a schedule of lease payments under the finance lease:

Period Ended	Minimum Lease Payment	=	Interest Expense	+	Reduction in Liability	Balance of Outstanding Liability
	(\$)		(\$)		(\$)	(\$)
30/06/X0	-		-		-	25,000
30/06/X1	6,427		2,250		4,177	20,823
30/06/X2	6,427		1,874		4,553	16,270
30/06/X3	6,427		1,464		4,963	11,307
30/06/X4	6,427		1,017		5,410	5,897
30/06/X5	6,427		530		5,897	0

An example of the journal entries for this lease arrangement is shown on the following page.

APPENDIX A (continued)

1. Initial recording of the leased asset and liability at fair value

DR	Plant and Equipment under Finance Lease	<i>(Increase in Asset – Balance Sheet)</i>	\$25,000
CR	Other Equipment Finance Lease Liability	<i>(Increase in Liability – Balance Sheet)</i>	\$25,000

2. First lease payment is made

DR	Finance Lease Interest	<i>(Increase in Expense – Operating Statement)</i>	\$2,250
DR	Plant and Equipment Finance Lease Liability	<i>(Decrease in Liability – Balance Sheet)</i>	\$4,177
CR	Cash at Bank	<i>(Decrease in Asset – Balance Sheet)</i>	\$6,427

3. Leased asset is depreciated for the period*

DR	Depreciation	<i>(Increase in Expense – Operating Statement)</i>	\$5,000
CR	Accumulated Depreciation – Plant and Equipment under Finance Lease	<i>(Increase in Contra Asset – Balance Sheet)</i>	\$5,000

* The leased asset is depreciated over its useful life of five years (assuming that the asset will be acquired by the lessee at the end of the lease term).

Journals 2 and 3 are repeated as payments are made and the depreciation expense is incurred during the term of the lease.

AGENCY AS LESSEE UNDER AN OPERATING LEASE – EXAMPLE

An Agency rents four floors of an office building from an external entity for an annual rent of \$125,000. The lease agreement is for an initial period of ten years. The lease is classified as an operating lease because an analysis of its substance shows that substantially all the risks and rewards incidental to ownership of the floor space will not pass to the Agency.

This determination is supported by the indicative criteria that:

- the lease term represents only 20% (10 years / 50 years useful life) of the useful life of the asset; and
- the present value of the minimum lease payments is substantially less than the fair value of the office space at the start of the lease.

An example of the journal entries (excluding GST) that would be expected to be processed each year under the operating lease are:

1. Lease expense is incurred

DR	General Property Management	<i>(Increase in Expense – Operating Statement)</i>	\$125,000
CR	Accounts Payable	<i>(Increase in Liability – Balance Sheet)</i>	\$125,000

2. Lessor is paid

DR	Accounts Payable	<i>(Decrease in Liability – Balance Sheet)</i>	\$125,000
CR	Cash at Bank	<i>(Decrease in Asset – Balance Sheet)</i>	\$125,000