PAPER ON THE ACCOUNTING ADVISORY FORUM

ACCOUNTING FOR LEASE CONTRACTS

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PAPER ON THE ACCOUNTING ADVISORY FORUM
ACCOUNTING FOR LEASE CONTRACTS

DOCUMENT

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PREFACE

This document deals with Accounting for Lease-contracts. It has been prepared by the Accounting Advisory Forum (Forum) as an advisory document to the Commission. The views expressed in this document do not necessarily represent a Commission's official position.

The Forum is an advisory body of experts from the main parties interested in accounting in the European Union. The Forum is not a standard-setting body. Its main function is to advise the Commission on accounting matters and possible ways to facilitate further harmonisation. The members of the Forum are invited on a personal basis. Their opinions, as expressed in this document, do not commit the organisations by whom they have been nominated, nor do they reflect the unanimous view of all the members.

The purpose of this publication is to stimulate discussions among standard-setters, preparers, users and auditors of accounts in Member States on the subject of Accounting for Lease-contracts. The document examines the various possibilities for furthering the presentation of comparable and equivalent information within the context of the Accounting Directives.

EXECUTIVE SUMMARY

SCOPE

This document deals with accounting for lease-contracts including agreements known in different countries by various terms such as lease purchase, hire purchase and 'crédit-bail' agreements. For the purpose of this document, a lease is defined as an agreement whereby the lessor conveys to the lessee in return for payment, the right to use an item of property for an agreed period of time.

TWO CONCEPTS: LEGAL VERSUS ECONOMIC OWNERSHIP

With regard to the accounting treatment of leases two main schools can be identified within the European Union. On the one hand, there are countries where the legal ownership concept is predominant. Under this concept, a leased asset should not be capitalised in the accounts of the lessee as the legal ownership of the asset remains with the lessor. In other countries, on the contrary, the economic ownership concept prevails. This concept goes beyond the legal title to the physical object and focuses on the rights and obligations relating to the economic risks and benefits. In this perception, it is the substance of the contract rather than the legal ownership of the property that predetermines the accounting treatment of leases, which can be divided into finance leases and operational leases. Under the economic ownership concept, a finance lease should be capitalised in the accounts of the lessee if substantially all risks and rewards incident to ownership have been transferred. To assess whether a lease-contract is a finance lease, the document provides a number of criteria which might indicate that substantially all risks and rewards incident to ownership have been transferred.

In some countries, the annual accounts are prepared in order to comply with tax requirements as well. The availability of tax and investment incentives is frequently rigidly linked to the way in which accounts are drawn up. The manner in which related tax advantages can be obtained is therefore of importance in developing rules for accounting for leases.

CONCLUSION

From the discussion in the Forum, as reflected in this document, it appears difficult at this stage to agree on a uniform accounting treatment, because of different approaches towards accounting for leases based upon economic, legal or tax considerations. For this reason, the document does not recommend a preferred method neither for the annual accounts nor for the consolidated accounts.

Article 29(2) of the 7th Directive gives the possibility to Member States to allow a parent company to use in its consolidated accounts other methods of valuation than those used in the annual accounts. This would open up the possibility of introducing a harmonised method of accounting for leases and classification of leases in the consolidated accounts regardless of tax and legal differences at the level of annual accounts. However, because of differences in opinion, as set out in paragraph 18 of this document, it was not possible based on the current discussions, to effectuate a distinction between the annual and consolidated accounts in accounting for leases and hence to introduce a uniform or preferred method for the consolidated accounts.

In order to establish at least a minimum of comparability, the Forum believes that it is necessary to require the lessee to disclose additional information concerning finance leases in the notes to the accounts where those finance leases are not capitalised in the balance sheet.

OTHER ASPECTS

Further recommendations are made for some specific cases, i.e. the accounting treatment of leases in the accounts of manufacturer/dealer lessors, for leases of land and buildings and for sale and leaseback transactions.

DISCLOSURES

The document concludes with a number of recommended disclosures in the accounts of the lessee and the lessor, which, inter alia, aim at restoring the comparability between the two methods (capitalisation/non-capitalisation) discussed.

COMPARISON WITH IAS 17

International Accounting Standard 17 - 'Accounting for Leases' makes a distinction between finance lease and operational lease and requires the capitalisation of an asset under a finance lease in the balance sheet of the lessee. The main difference between IAS 17 and this Forum document is that whereas IAS 17 has adopted the economic ownership concept, the Forum document concludes that in a European context both the method which gives priority to the legal ownership and the method which puts the emphasis on the economic ownership should be allowed as alternative treatments.

INTRODUCTION

1. Leases and hire purchase contracts are means by which companies obtain the right to use or purchase assets. Leasing is a major alternative to outright purchase of equipment in many countries. The growing importance of leasing has become evident in the last decades. The flexibility and economic advantages of the leasing techniques enabled leasing to enter the field of industrial investment in Europe and world-wide. The leasing market is still growing and diversifying despite the reduction in available tax benefits in some countries. In addition to the availability of tax allowances, other factors such as cash flow and other economic considerations play a role in opting for leasing instead of buying.

   Accounting for leases reflects the different approaches of accounting in general within which leases are treated. In some countries the legal ownership concept of the leased assets is stressed as opposed to other countries where the rights of usage and the bearing of risks are stressed. In the latter countries it is the substance of the contract that counts. This is usually referred to as substance over form. In those countries where the annual accounts are also used for tax purposes accounting for leases is often heavily influenced by tax considerations.

2. The European Community addresses leasing only indirectly in the Fourth Directive.

   Article 2.1 of the Fourth Directive states:

   "1. The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole."

   Article 43.1.(7) of the Fourth Directive states:

   "1. In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:

   (7) the total amount of any financial commitments that are not included in the balance sheet, in so far as this information is of assistance in assessing the financial position. Any commitments concerning pensions and affiliated undertakings must be disclosed separately;"

   In the light of the call for the presentation of comparable and equivalent information as laid down in the fifth preamble of the Fourth Directive:

   "Whereas the different methods for the valuation of assets and liabilities must be co-ordinated to the extent necessary to ensure that annual accounts disclose comparable and equivalent information."

this document examines the various possibilities for furthering the presentation of comparable and equivalent information in order to reflect leasing in the accounts and/or notes to the accounts of both the lessee and the lessor.

3. This document deals with accounting for lease contracts including agreements known in different countries by various terms such as lease purchase, hire purchase and "crédit-bail" agreements.

DEFINITIONS

4. The following terms are used in this document with the meanings specified:

Lease: an agreement whereby the lessor conveys to the lessee in return for payment the right to use an item of property for an agreed period of time.

Finance lease: a lease that transfers substantially all the risks and rewards incident to ownership of an item of property. Title may or may not be transferred at the end of the lease. Paragraph 9 provides some criteria for the interpretation of "substantially all".

Operating lease: a lease other than a finance lease.

Non-cancellable lease: a lease that is cancellable only: (a) upon the occurrence of some remote contingency, (b) with the permission of the lessor, (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor, or (d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Inception of the lease: the earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.

Lease term: the non-cancellable period for which the lessee has contracted to lease the item of property together with any further terms for which the lessee has the option to continue to lease the item of property, with or without further payments, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum lease payments: the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with, to the extent that it is likely that the amounts guaranteed will be paid or received:

(a) in the case of the lessee, any amounts guaranteed by him or by a party related to him; or

(b) in the case of the lessor, any residual value guaranteed to him by either the lessee or a party related to the lessee or an independent third party financially capable of meeting this guarantee.

However, if the lessee has the option to purchase the item of property at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable and if, at the inception of the lease, it is reasonably certain that the option will be exercised, the minimum lease payments comprise the amounts payable over the lease term and the payment required to exercise this purchase option.

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

Useful life: is either (a) the period over which a depreciable asset is expected to be used by the enterprise; or (b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Unguaranteed residual value: that portion of the residual value of the leased item of property (estimated at the inception of the lease), the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

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

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

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

Net cash investment: the balance of the cash outflows and inflows in respect of the lease excluding flows relating to insurance, maintenance and similar costs rechargeable to the lessee. The cash outflows include payments made to acquire the item of property, tax payments, interest and principal on third party financing.

Interest rate implicit in the lease: the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments, from the standpoint of the lessor, and (b) the unguaranteed residual value to be equal to the fair value of the leased item of property.

Lessee's incremental borrowing rate of interest: the rate of interest that, at the inception of the lease, the lessee would incur to borrow over a similar term and with a similar security the funds necessary to purchase the leased item of property.

Finance charge: the amount borne by the lessee over the lease term, representing the difference between the total of the minimum lease payments (including any residual amounts guaranteed by him) and the amount at which he records the leased item of property at the inception of the lease.

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

Annual accounts are defined in Article 2 of the Fourth Directive. Consolidated accounts are defined in Article 16 of the Seventh Directive.

In Annex II, the above definitions are presented in alphabetical order.

CLASSIFICATION OF LEASE CONTRACTS

5. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions and the accounting treatments recommended should ideally be complementary, otherwise the same assets would be capitalised twice or not at all. Such situations should be avoided, although it will not be possible to eliminate them entirely. Nevertheless, the application of these definitions in practice to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by lessor and lessee. This might happen in particular in the case of cross border lease contracts or third party guarantees.

6. In some countries, as shown in Annex I, and in IAS 17 "Accounting for leases" a classification of leases is used, in order to be able to apply the accounting and/or disclosure requirements. In other countries, leases are not classified and for accounting and disclosure purposes are treated in the same way.

7. When a classification is provided, leases are usually divided into finance leases and operating leases. However, in some countries other intermediate forms are distinguished as well. For the lessor sometimes a different sub-classification is used, for instance sales-type leases, direct financing leases and operating leases. However, the most widely supported classification is the classification into finance leases and operating leases, for both the lessee and the lessor. The distinction between a finance lease and an operating lease can be deduced from the terms of the contract between the lessor and the lessee and is based on the extent to which risks and rewards incident to ownership of a leased item of property lie with the lessor or the lessee.

8. Those who are in favour of such a classification argue that the classification, i.e. whether a lease is a finance lease or not, depends on the substance of the contract rather than the legal ownership of the items of property. This concept is usually referred to as the economic perspective or as economic or effective ownership. The concept goes beyond the legal title to the physical object and focuses on the rights and obligations relating to economic risks and benefits. Although the legal title to the leased item of property remains with the lessor, the rights of usage are given to the lessee. There is therefore no reason why both the lessor and the lessee should not view their respective bundles of rights as separate aspects of one physical object and value and record these rights as assets. Moreover, on the condition that the lease payments remain the same during the contract, the economic approach, contrary to the legal approach, leads to an appropriate matching of income and charges. The lease payments comprise an interest element, an amortisation element and a service element. The service element remains the same, the interest element decreases and the amortisation element

increases during the lease term. Because the benefits from the underlying item of property decrease during the lease term, the legal approach leads to a mismatch between the benefits derived from the item of property (decreasing during the lease term) and the recognised amortisation costs allocated to that item of property (increasing during the lease term).

The effect of a lease is to create a set of rights and obligations related to the use and enjoyment by the lessee of a leased item of property for the term of the lease. Where the lease contract results in the transfer of rights and obligations to the lessee to such an extent that he assumes risks and obtains rewards substantially similar to those of an outright purchase of the item of property in question, the lease will be a finance lease, irrespective of whether there is a transfer of legal title. Conceptually this would mean that what is capitalised in the lessee's accounts is not the title to the item of property itself but, as stated before, his rights vested in the item of property. By the same token, the lessor in substance has a debtor.

9. Under the economic concept outlined above a lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. In order to assess this, various criteria are used. However, whether or not "substantially all the risks and rewards" have been transferred can only be determined by taking into account all the elements of the contract together, with emphasis on the economic substance of the contract. The service element of the lease contract should be ignored. A lease is classified as an operating lease if substantially all the risks and rewards incident to ownership are not transferred. An operating lease usually involves the lessee paying a rental for the hire of an item of property for a period of time which is normally substantially less than its useful economic life.

Some of the criteria that might be used in order to assess, at the inception of the lease, whether risks and rewards are transferred include the following:

(a) The lease transfers automatically the legal ownership of the item of property to the lessee by the end of the lease term.

(b) The lessee has the option to purchase the item of property at a price which is expected to be substantially lower than the fair value at the date the option becomes exercisable, so that, at the inception of the lease, it is reasonably certain that the option will be exercised.

(c) The lease term is for the major part of the remaining useful life of the item of property. Title may or may not eventually be transferred.

(d) The present value at the inception of the lease of the minimum lease payments is greater than or equal to the fair value of the leased item of property net of grants and tax credits to the lessor at that time. Title may or may not eventually be transferred.

(e) The lessee will be entitled, during or immediately after the expire of the period for which the lessor has committed himself, to purchase the item of property at a price substantially below its market value.

(f) The lessee is committed for a shorter period than the economic life of the asset, but has been granted an option at a considerably lower rental for the ensuing period up to approximately the end of the economic life of the item of property.

(g) The lease secures for the lessor the recovery of his capital outlay plus a return on the funds invested, in particular where it is combined with an option.

It should however be observed that the above mentioned criteria are of different importance and that one criterion is not necessarily sufficient to indicate whether substantially all risks and rewards incident to ownership have been transferred.

10. The position taken by an enterprise regarding capitalisation of lease contracts is often influenced by its view of off-balance sheet financing. This position is especially relevant in those countries where neither the legal system nor the tax regulations influence the classification of a lease as a finance lease or an operating lease. Off-balance sheet financing is an approach that enables the lessee not to recognise certain liabilities in the balance sheet. Consequently, the balance sheet shows a more favourable debt/equity ratio than when the liability and the item of property are recognised in the balance sheet. This practice highlights the degree of subjectivity that is applied in interpreting a specific contract as being a finance or an operating lease contract, thus emphasising the need for a clearly defined distinction between finance and operating leases.

11. Arguments in favour of not classifying leases into finance leases and operating leases are generally based on an interpretation of legality, on simplicity or on avoidance of arbitrary criteria for distinguishing between the two categories of leases. Another advantage of not classifying leases would be that this approach improves objectivity and harmonisation and will enhance the comparability of accounting for leased items of property, provided that additional information on the related liabilities is disclosed in the notes to the accounts. The proponents of not classifying leases can be subdivided into two groups: those who support the concept of legal ownership and those who are of the opinion that all leases should lead to the recognition of an asset by the lessee.

12. The legal approach (only capitalising leases in the accounts of the legal owner, normally the lessor) underlines the fact that the lessee does not have legal title to the item of property and obtains only the use of the services from the item of property for the period of the lease and ownership of the item of property remains with the lessor. Consequently, the leased object remains an asset of the lessor and does not become an asset of the lessee during the term of the lease. In some countries it is prohibited for the lessee to recognise a leased item as an asset. It is also considered incorrect to capitalise the future obligations under the lease contract in the same way as a loan because a lease is regarded as being

different from a loan. The basis for the accounting treatment in these countries stems from either a legislative requirement to recognise assets only on the basis of legal title or from similar specific requirements in order to obtain a tax advantage. The legal title argument is connected to the ownership of assets in case of liquidation. Another advantage of the legal approach is that there is no situation in which an item of property is recognised twice or not at all, because there is only one legal owner.

13. Others, whilst believing that lessees obtain assets and liabilities under lease contracts which should be included in the balance sheet, and hence that accounting under the legal ownership approach is fundamentally unsatisfactory, also consider that the approach which requires leases to be classified into two types with a fundamentally different accounting treatment for each type is wrong in principle. They argue that there is no essential difference between so-called finance leases and operating leases and whatever criterion or combination of criteria is used, there will inevitably be leases which are essentially similar yet are classified differently, and hence give rise to completely different accounting treatments and practical difficulties. In their view, the same accounting principles (i.e. capitalisation by the lessee) should apply to all leases, whereby the extent of capitalisation depends usually on the length of the lease term. This would be effected by recognising an obligation equivalent to the present value of the minimum lease payments and a corresponding asset representing the rights to use the equipment.

    The implication of this approach for lessors is that they should also adopt a method of accounting for leases which draws no distinction between finance leases and operating leases. The granting of a lease transforms a lessor's investment in physical property into two assets : the right to receive lease payments, and the right to the return of the property at the end of the lease. These two kinds of assets are fundamentally different, especially in the risks to which they are exposed: lease payments are essentially at risk to default on the part of the lessee, whereas residual values are at risk to changes in the market for the kind of equipment in question. It therefore seems particularly important that accounts of lessors should disclose separately these two kinds of assets.

    Opponents of this method argue that it opens the door to the capitalisation of all sorts of other rights, which gives rise to doubts as to whether it is in line with the Fourth Directive. Moreover, the underlying assumption that where a liability exists, there should also be an asset, does not always hold.

    It should be noted that this method of accounting is not currently required or even applied in any Member State. It is a relatively new idea which would have many practical implications not all of which have yet been identified and assessed. This method might raise some difficulties which cannot be solved within the scope of this document.

14. Another point of view constitutes a combination of the legal approach and the economic ownership approach. The legal approach is followed with respect to the lessor and the economic approach for the lessee, whereby finance leases are

capitalised as intangible fixed assets. The argument put forward in favour of capitalising finance leases as intangible fixed assets is that the lessee does not acquire the leased item of property itself but a bundle of rights to use the leased item of property.

15. In some countries, accounting principles applied in annual accounts are not always based on the same principles as those which are applied for tax purposes. In other countries the annual accounts are prepared in order to comply with tax requirements as well, and consequently embody concurrent principles for both accounting and tax purposes. The availability of tax and investment incentives is thus frequently rigidly linked to the way in which accounts are drawn up. Capitalisation of leases by the lessee may possibly jeopardise a lessor's right to tax benefits and investment credits and hence limit the financing possibilities of the lessor. Conversely, capitalisation of leases by the lessor may possibly jeopardise a lessee's right to tax benefits and investment credits. The manner in which related tax advantages can be obtained is of importance in developing rules for accounting for leases.

CONCLUSIONS

16. The above and Annex I show that leases are treated in many different ways. In addition, it appears difficult to agree on a uniform accounting treatment, because of different approaches towards accounting for leases based upon economic, legal or tax considerations.

    In other areas, where it appeared impossible to agree on a uniform accounting treatment, the 4th Directive has tried to restore comparability through additional disclosures in the notes. For lease contracts, no specific note disclosures are required by the 4th Directive. Indeed, although it is generally agreed that the commitments resulting for the lessee from a finance lease, would qualify for disclosure in the notes on the accounts by virtue of Article 43.1(7) of the 4th Directive, there is no requirement to disclose the lease commitments separately from other financial commitments.

17. In order to establish at least a minimum comparability, it would therefore appear at least necessary to require the lessee to disclose additional information concerning finance leases in the notes, where those finance leases are not capitalised in the balance sheet. This additional requirement would allow both methods capitalisation and non-capitalisation - to continue to exist without ruling out one method in favour of the other. It is clear that this solution presupposes a classification of lease contracts into finance leases and operating leases.

18. Because of the impossibility to agree on a uniform accounting treatment in the annual accounts, it has been suggested to go a step further in the consolidated accounts. For consolidated accounts the tax linkage is normally less of an obstacle. In addition, Article 29.1 of the 7th Directive requires all assets and liabilities to be included in consolidated accounts to be valued according to uniform methods. Member States may allow a parent undertaking to use in its

consolidated accounts other methods of valuation than those used in its annual accounts (Article 29.2). This opens the possibility of introducing a harmonised method for accounting for leases and classification of leases in the consolidated accounts despite tax and legal differences at the level of annual accounts.

Some people do however in this case oppose to making a distinction between annual and consolidated accounts. They argue that for a majority of companies which come under the Accounting Directives, the annual accounts constitute the only, or if combined with the consolidated accounts, an important information source. Besides, they argue that what is valid ('true and fair') for the consolidated accounts should in principle equally be valid ('true and fair') for the annual accounts.

In other cases, for instance with regard to 'foreign currency translation' (see XV/304/91-EN), a departure from the basic principle of equal treatment can be condoned because tax considerations might preclude the application of an equal accounting treatment in both the annual and consolidated accounts. This is less obvious in the case of lease-contracts, therefore it is argued that the accounting treatment for lease-contracts relates equally to the annual and consolidated accounts. If, nevertheless, such tax considerations do exist, they cannot be ignored.

However, these arguments are not always valid, as is illustrated by the fact that several parent companies within the Community actually operate a distinction between the annual and consolidated accounts and that at least one Member State has explicitly allowed the operation of such a distinction, regarding accounting for lease-contracts. Because of the differences in opinion, it is not possible based on the current discussions, to effectuate a distinction between the annual and consolidated accounts in accounting for lease-contracts and hence to introduce a preferred method for the consolidated accounts.

ACCOUNTING TREATMENT OF LEASE CONTRACTS (IN ANNUAL AND CONSOLIDATED ACCOUNTS)

19. Accounting for leased items in the accounts of the lessor would usually mirror the treatment adopted by the lessee since, both from a legal view and from an economic view, the ownership of the leased item of property is either with the lessor or the lessee; it cannot be with both. Where, however, there is a third party guarantor of residual value it may be that the lease is properly classified as an operating lease by the lessee, but as a finance lease by the lessor. Similarly, in other circumstances there may also be reason to classify a lease differently as between the lessor and the lessee, for example where the lessor uses the implicit interest rate in the lease to discount lease payments but the lessee is obliged to use his incremental borrowing rate. Another example is where the definition of minimum lease payments is differently formulated for the lessee and for the lessor.

THE ACCOUNTS OF LESSEES

20. A distinction should be made between finance leases and operating leases. A finance lease is defined in paragraph 4. Further criteria for identifying a finance lease are given in paragraph 9. Where a finance lease is capitalised by the lessee, paragraphs 21 through 23 apply. Where a finance lease is not capitalised by the lessee, it must be accounted for as an operating lease in accordance with paragraph 24. In order to establish comparability between the two methods, the lessee will in such case provide for additional disclosures in the notes in conformity with paragraph 47.

Finance leases which are capitalised by the lessee

21. The finance lease is recorded in the balance sheet of a lessee as an asset with a corresponding obligation to make future lease payments. The rights and obligations arising from a finance lease are recorded at the beginning of the lease term at the present value of the minimum lease payments (after deduction of the service element). If, however, the fair value is lower than the present value of the minimum lease payments, than fair value is used. At the inception of the lease, the asset and the liability for the future lease payments are recorded in the balance sheet at the same amounts. In calculating the present value of the minimum lease payments the discount factor is the interest rate implicit in the lease, if it is practicable to determine; if not, the lessee's incremental borrowing rate may be used).

22. The item of property leased under the finance lease is depreciated over the shorter of the lease term or its useful economic life. If it is reasonably certain that the lessee will obtain legal ownership by the end of the lease term, the depreciation period is useful economic life. In that case, the depreciable amount of a leased item of property is allocated to each accounting period on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable items of property that are owned.

23. Lease payments are apportioned between the finance charge and a reduction of the outstanding obligation for future amounts payable. The difference between the total minimum lease payments over the lease term and the initially recorded present value of the liability represents the finance charge. The finance charge is allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability during each period. In practice, some form of approximation is often used to simplify the calculation.

Operating leases and finance leases which are not capitalised by the lessee

24. The lease payments are charged on a systematic basis over the lease term, even if the payments are not made on such a basis. Lease payments should exclude costs of services such as insurance and maintenance.

THE ACCOUNTS OF LESSORS

25. A distinction should be made between finance leases and operating leases. A finance lease is defined in paragraph 4. Further criteria for identifying a finance lease are given in paragraph 9. Where a finance lease is not capitalised by the lessor, paragraphs 26 through 29 apply. Where a finance lease or an operating lease is capitalised by the lessor, it must be accounted for in accordance with paragraph 30 through 32.

Finance leases which are not capitalised by the lessor

26. The amount due from the lessee under a finance lease is recorded in the balance sheet of a lessor as a debtor at the amount of the net investment in the lease after value adjustments for items such as bad and doubtful lease payments receivable. The item of property held under the finance lease should preferably not be recorded as a tangible fixed asset, as under a finance lease substantially all the risks and rewards incident to economic ownership are transferred by the lessor, and thus lease payments receivable are treated by the lessor as repayments of principal and finance income to reimburse and reward it for its investment and its services.

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

27. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value the income allocation over the lease term is revised and any reduction in respect of amounts already accrued is immediately included as a charge in the profit and loss account.

28. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial costs are incurred to produce finance income and may either be expensed immediately or allocated against this income over the lease term. The latter may be achieved by charging in the profit and loss account the cost as incurred and recognising as income in the same period a portion of the unearned finance income equal to the initial direct cost.

29. Finance lease transactions can be structured in such a way that they involve at least three parties, the lessee, the lessor and one or more long-term creditors who provide part of the acquisition finance for the leased item of property. The lessor records its investment in the lease net of the non-recourse debt and the related finance costs to the third-party creditors and recognises finance income on the basis of the lessor's net cash investment outstanding in respect of the finance lease.

Operating leases and finance leases which are capitalised by the lessor

30. The item of property held for use by the lessee under the lease contract is recorded as a fixed asset in the balance sheet of the lessor and depreciated over its useful economic life. Under an operating lease, the risks and rewards incident to ownership of an item of property remain with the lessor. Therefore, the item of property is treated by the lessor as a depreciable asset and lease payments receivable are included as income in the profit and loss account over the lease term.

31. The leased asset is depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets: the depreciable amount of the asset being allocated on a systematic basis to each accounting period during its useful economic life.

32. Costs, including depreciation, incurred in earning the income from the lease contract are charged in the profit and loss account. The income from the lease contract (excluding receipts for services provided such as insurance and maintenance) is recognised on a systematic basis over the lease term even if the receipts are not on such a basis.

MANUFACTURER/DEALER LESSOR

33. Manufacturers or dealers often offer to customers the choice of either buying or leasing an item of property. A finance lease of an item of property by a manufacturer or dealer lessor gives rise to two types of income:

    (a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the item of property being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

    (b) the finance income over the lease term.

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

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit should be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are usually charged to the profit and loss account at the inception of the lease because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. A manufacturer or dealer lessor should not recognise a selling profit under an operating lease.

LAND AND BUILDINGS

38. Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets. If a building and the related land are leased at the same time, the criteria to differentiate between a finance and an operating lease should be applied to :

  - the whole package, if it is one contract and the lease of the building is related to the lease of the land ;

  - each of the two items of property separately if the two leases are not related.

  A characteristic of land is that it normally has an indefinite useful life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee does not receive substantially all of the risks and rewards incident to ownership. Such a lease is therefore normally classified as an operating lease. An up front payment made for such a leasehold is capitalised and amortised over the lease term.

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

SALE AND LEASEBACK TRANSACTIONS

39. A sale and leaseback transaction involves the sale of an item of property by the vendor and the leasing of the same item of property back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package and neither of them individually necessarily represents fair value.

  Accounting by the seller/lessee

40. It is assumed that every leaseback is a finance lease unless the lessee proves that it is an operating lease. The transaction is normally a means whereby the lessor provides finance to the lessee, comparable to a secured loan. For this reason it is not appropriate to regard an excess of sales proceeds over the carrying amount as

a realised profit. Such excess, if recognised, is deferred and amortised in the accounts of the seller/lessee over the shorter of the lease term and the useful economic life of the asset.

41. If the leaseback is proved to be an operating lease, any profit or loss should be recognised immediately, provided it is clear the sales price and the lease terms are established at fair value. If they are not established at fair value, the profit must be deferred over the lease term.

42. For operating leases, if the fair value at the time of the transaction is less than the carrying amount, a loss equal to the amount of the difference between the carrying amount and fair value is recognised immediately. For finance leases, no such adjustment is necessary unless there has been a permanent impairment of value.

Accounting by the buyer/lessor

43. A buyer/lessor should account for a sale and leaseback transaction in the same way as it accounts for leases, that is, by using the methods set out in paragraphs 25 to 32 above.

DISCLOSURE IN THE ANNUAL AND CONSOLIDATED ACCOUNTS

Disclosures in the Accounts of Lessees

44. The methods used to classify and to value leases should be disclosed in the notes on the accounts (Article 43.1.(1) of the Fourth Directive and Article 34.1 of the Seventh Directive).

45. When finance leases are capitalised by the lessee, the accounts should provide the following information in the balance sheet :

    (a) Original cost of items of property that are the subject of finance leases together with the related accumulated depreciation by each major class of assets. The amount of depreciation allocated for the period in respect of items of property held under finance leases included in the overall total should also be disclosed. Capitalised leased items of property should be included as a separate category in the movements schedule required by Article 15 of the Fourth Directive.

    (b) The amount of obligations related to finance leases (net of finance charges allocated to future periods) should be disclosed separately from other obligations and liabilities. They should be split between amounts becoming due and payable within one year and amounts becoming due and payable after more than one year. Amounts due and payable after more than 5 years are disclosed in the notes in conformity with Article 43.1 (6) of the 4th Directive.

46. When finance leases are not capitalised by the lessee the following disclosures are required in the notes:

    a) Commitments for minimum lease payments under finance leases with a term of more than one year (in accordance with Article 43.1.(7) of the Fourth Directive).

    b) The total of lease payments charged as an expense in the profit and loss account that relate to finance leases and the finance charge included in these payments.

47. Should one wish to establish a full reconciliation between the two methods, the following disclosures would also be necessary :

    - in the case of capitalisation by the lessee : the commitments for minimum lease payments under finance leases with a term of more than one year ;

    - in the case of non capitalisation by the lessee : the original cost of the items of property related to finance leases and the related accumulated depreciation and depreciation for the period, as if they had been capitalised for each major class of assets.

48. Commitments for minimum lease payments under non cancellable operating leases with a term of more than one year should be disclosed in the notes, in accordance with Article 43.1.(7) of the Fourth Directive.

Disclosures in the Accounts of Lessors

49. The methods used to classify and to value leases should be disclosed in the notes on the accounts (Article 43.1.(1) of the Fourth Directive and Article 34.1 of the Seventh Directive).

50. Accounts should give the following disclosures:

    a) Net investment in finance leases.

    b) Original cost of items of property held for use in operating leases and the related accumulated depreciation charges and the depreciation for the period by each major class of assets as part of the movements schedule as required by Article 15 of the Fourth Directive.

51. Where finance leases are not accounted for as receivables in the accounts of the lessor, all leases are accounted for in the accounts of the lessor as operating leases, which would require the disclosure as mentioned in paragraph 50 b) to be made.

    In such a case, additional disclosure is required in the notes, for those leases that from the economic perspective would be seen as finance leases, of the portion of original cost of items of property as disclosed in paragraphs 50 b) which are in fact used for finance leases.

ANNEX I

LEGAL AND OTHER REQUIREMENTS ON ACCOUNTING FOR LEASE CONTRACTS

1. Accounting and disclosure requirements on lease contracts included in the law

Accounting and disclosure requirements regarding lease contracts are not specifically addressed by the law in the following countries:

- Germany
- Ireland
- Italy
- Luxembourg
- Netherlands

However, it should be noted that in the above countries leasing is covered by the legal provisions on financial commitments that are not included in the balance sheet, in accordance with the Fourth Directive. Article 43.1.(7) of the Fourth Directive states that:

"1. In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:

(7) ....the total amount of any financial commitments that are not included in the balance sheet, in so far as this information is of assistance in assessing the financial position. Any commitments concerning pensions and affiliated undertakings must be disclosed separately;"

The following gives a summary of the legal requirements in the countries in which leasing is addressed by law.

Belgium

In Belgium, lease contracts are subject to the requirements of a Royal Decree (of 8 October 1976 on the annual accounts of enterprises, amended several times) enacted in pursuance of the law of 17 July 1975 on accounting and the annual accounts of enterprises.

The Belgian accounting legislation only provides for a definition of finance leases. The conditions to fulfil in order to classify a leasing operation as a financial lease differ depending on whether the lease contract relates to movable or immovable property.

Immovable property: The long term rights (to use developed immovable property which the enterprise has by virtue of long term leases, building rights, leasing and other similar non-cancellable contracts) will be included under finance leases under the following conditions:

a. the instalments foreseen in the contract cover the entire capital invested by the lessor in the property including interest and ancillary costs; and

b. title to the property will be transferred automatically to the enterprise at the end of the contract or the contract includes a purchase option for the enterprise.

Movable property: The right to use movable property which the enterprise has by virtue of leasing or similar non-cancellable contracts will be included under finance leases, provided that :

a. the instalments foreseen in the contracts, increased by the amounts payable if the purchase option is exercised, cover the entire capital invested by the lessor for the acquisition of the property, including interest and ancillary costs; and

b. title to the property will be transferred automatically to the enterprise at the end of the contract of that the contract includes a purchase option for the enterprise.

The Commission of Accounting Standards has stressed the importance of the 'substance over form' principle by providing in a statement for some examples of lease agreements on movable property which have to be included under finance leases:

- the contract grants no purchase option to the lessee, but gives to the lessor the right to compel the lessee to purchase at the end of the contract;

- the contract grants no purchase option to the lessee, but gives to the latter the right to cancel the contract in advance if he finds a purchaser for the property and if he pays the remaining capital portion of the instalments to the lessor.

According to the Belgian accounting legislation, operating leases are long term contracts with conditions other than those defined for finance leases.

1. Accounting treatment of finance leases:

1.1. LESSEE

1.1.1. Accounting treatment in the balance sheet

1.1.1.1. Fixed assets
Tangible assets
III.D. Leasing and other similar rights
Valuation

a) Recorded as an asset to the extent of the capital portion of the instalments payable under the lease agreement representing the capital value of the assets to which the agreement relates.
b) Depreciation as economically justifiable with respect to the nature of the asset.

1.1.1.2. Liabilities
Creditors
VIII. Amounts payable after one year
A. Financial debts
3. Leasing and other similar obligations
IX. Amounts payable within one year
A. Current portion of amounts payable after one year
Valuation

On the liabilities side shall be recorded each year the capital portion of the instalments to be paid in the future periods, in order to reconstitute the capital value of the asset to which the agreement relates.

1.1.2. Recognition of income

Income statement

II. Operating charges
D. Depreciation and other amounts written off from
formation expenses,
intangible and tangible assets (for the amount of the periodical depreciation)

V. Financial charges
A. Interest and other debt charges (for portion of interest in the periodical instalment)

In both cases, the charges are accounted for together with other charges of the same nature without any distinction.

1.1.3. Disclosure requirements in the notes

1.1.3.1. The valuation rules.

1.1.3.2. In the "Statement of tangible assets"

Caption: "Leasing and other rights"

- acquisition cost, at the end of the preceding period, movements (detailed as per nature) during the period and the amount at the end of the period;
- revaluation surpluses existing at the end of the preceding period, movements (detailed as per nature) during the period and the amount of these revaluation surpluses at the end of the period;
- depreciation and amounts written down at the end of the preceding period, movements (detailed as per nature) during the period and the balance of depreciations and amounts written down at the end of the period;
- the net carrying value at the end of the period.

In respect of the rights the enterprise has under leasing or similar contracts, the net carrying value at the end of the period shall be analysed between: land and buildings, plant, machinery and equipment, furniture and vehicles.

1.1.3.3. In the "Statement of amounts payable"

a) an analysis of the tangible fixed assets caption "Leasing and other similar rights" of amounts originally payable after one year, indicating whether the residual term is not more than one year, between one and five years, or over five years.

b) an analysis of the amounts payable or the portion thereof that are guaranteed:

1. by Belgian public authorities;
2. by real guarantees given or irrevocably promised on the enterprise's assets;

but without indication of their term.

1.1.3.4 In case of the application of an accelerated depreciation plan in accordance with relevant tax regulations: should such a plan lead to a more rapid depreciation than can be economically justified, the difference between the accumulated depreciation charged and the amount of the depreciation economically justifiable, shall be disclosed. Shall also be disclosed the impact of the accelerated depreciation charged during the period or during previous periods on the amount of depreciation shown in the income statement of the period.

1.1.4. Other requirements

If according to relevant tax regulations in the individual financial statements charges for depreciation or amounts written down are applied higher than economically justified, of an enterprise taken into consolidation, these items can only be taken into the consolidated accounts after having eliminated these distortions. This procedure is not applicable if the importance of the concerned amounts is negligible.

The enterprise disposes of the possibility not to rectify these distortions, on condition that the impact on the results of the financial period should be mentioned in the notes.

1.1.5. Remarks

Assuming the purchase option is exercised, the lessee will account for the price of this option among the tangible assets, under the appropriate caption, and charge depreciation on it; if necessary, these assets shall be subject to supplementary or exceptional depreciation when their carrying value exceeds their value to the enterprise.

Under the same assumptions, the lessor will account for a "gain on disposal of tangible fixed assets".

1.2. LESSOR

1.2.1. Accounting treatment in the balance sheet

Current assets
V. Amounts receivable after one year
A. Trade debtors

VII. Amounts receivable within one year
A. Trade debtors
Valuation

See Lessee: liabilities

1.2.2. Recognition of income

Income statement
IV. Financial income
B. Income from current assets (for the portion of interest in the periodical instalment)
The profit is recorded together with other profits of the same general origin (current assets) without any distinction.

1.2.3. Disclosure requirements in the notes: nothing

1.2.4. Remark

The Commission of Accounting Standards allows that the amount payable if the purchase option is exercised would be accounted for among the "Other tangible fixed assets" from the outset of the contract, in the case that certainty exists that the option will be exercised.

2. *Accounting treatment for operating leases:*

2.1. LESSEE

2.1.1. Accounting treatment in the balance sheet: Nothing

2.1.2. Recognition in income

The periodical payments are recorded in the income statement without any distinction with the other items under a general caption.

II. Operating charges
B. Services and other goods

2.1.3. Disclosure requirements: nothing

2.1.4. Other requirements: obligation to mention the contracts in the notes to the annual accounts if they have a significant effect on the results of the enterprise.

2.2. LESSOR

2.2.1. Accounting treatment in the balance sheet

Fixed assets
III. Tangible assets
E. Other tangible assets

VI. Stocks and contracts in progress
A. Stocks
Valuation

a) at acquisition cost: purchase price production cost assigned value (agreed value of contribution in kind)
b) depreciation as economically justifiable with respect to the nature of the asset

2.2.2. Recognition in income

Income statement

a) II. Operating charges
D. Depreciation and other amounts written off from formation expenses, intangible and tangible assets (for the year depreciation of the respective assets)

b) If the long term contract activity belongs to the normal activity of the enterprise, the rental income is recorded under

I Operating income
A. Turnover
(together with, and without any distinction from, the other items of that income caption)

c) if the long term contract activity cannot be considered as belonging to the normal activity of the enterprise, then the rental income is recorded under:

I. Operating income
D. Other operating income
(together with, and without any distinction from, the other items of that income caption)

2.2.3. Disclosure requirements

In the notes in the movements schedule (as per detail in Finance Lease) for the caption "Other tangible assets", without any distinction from other assets of the same caption.

Denmark

In Denmark, there is a limited number of statutory requirements as to accounting for leases and the disclosure of information in this respect. The legal basis is laid down in section 46 (3) of the Danish Company Accounts Act of 1981, which should not be considered exhaustive, however. This provision was adopted in connection with the implementation of the Fourth Directive.

According to this provision, information must be disclosed about rental and leasing commitments which are of significant importance to the operation of the company. Thus, the value of the maximum capitalised commitment or the annual rent payable, as well as the term of the lease must be disclosed. These requirements apply to both the lessor and the lessee.

The Danish Presentation of Accounts Act only requires disclosure in the notes and thus has not taken into account the capitalisation of leased assets in the balance sheet. According to ° 4 of the Act (article 2, section 3, of the Fourth Directive) a capitalisation of financially leased assets may be allowed or may be necessary with reference to the true and fair view. The Presentation of Accounts Act makes no distinction between finance leases and operating leases. There are no statutory provisions stipulating how rental and leasing commitments are to be shown in the profit and loss account, neither for the lessor nor for the lessee. In those instances where finance leases are identified separately and capitalised the provisions of IAS 17 tend to be adhered to.

France

Annual accounts

The general rule in France is to expense leases in the accounting period. There is no distinction between operating leases and financial leases, but a certain type of finance lease has expressly been dealt with in the law. These contracts called "crédit bail" are set up by credit institutions and include specific features such as an option of purchase granted to the lessee. Although other types of finance lease contracts may be set up, "crédit bail" contracts are the most widely used.

For this particular type of contract, specific rules apply (Decree of 29 November 1983 and Plan Comptable Général 1982). The required accounting treatment may be summarised as follows:

A. During the life of the lease contract

(a) the leased asset cannot be capitalised, as the user has no title to it as long as he has not exercised the acquisition option;

(b) rental expenses are recorded in a specific expense account and must be separately disclosed in the profit and loss account;

(c) the following disclosures must be made (decree # 72-665 of July 4, 1972 and art. 53 of the decree of November 29, 1983):

i) fair value of the asset at inception of the lease contract;
ii) rental expense for the year, and cumulative rental expenses up to the balance sheet date;
iii) theoretical allowance for depreciation of the asset as if it had been acquired, and accumulated depreciation up to the balance sheet date;
iv) amount of residual rental payments to be made after the balance sheet date (following year, between 1 and 5 years, after 5 years);
v) acquisition cost at expiration date of the lease contract.

B. At the expiration date of the lease contract

(a) the asset is capitalised at the acquisition cost as per the lease contract;
(b) the asset is depreciated over its residual useful life at the expired date of the lease contract;
(c) any future sale is accounted for as the normal sale of an asset.

The same treatment is applicable for tax purposes, except for leased property, where specific tax rules apply.

The same treatment as above applies mutatis mutandis for the lessor.

The capital gains realised in a sale and lease-back transaction can either be amortised over the remaining life of the lease-back contract, or immediately taken to income. Taxwise, immediate recognition applies.

Consolidated accounts

As an optional accounting treatment, the lessee may, in its consolidated financial statements only (art. 248-8 of the decree of March 23, 1967, in application of art. 357-8 of the Law of July 24, 1966, both as later modified), account for any lease with an acquisition option "as if the asset had been acquired". Under this treatment, the amount to be capitalised is the fair value (normally as per the lease contract) of the asset, and the corresponding debt is accounted for on the liability side of the balance sheet. The asset is depreciated over its useful life. The rental expense is cancelled, and an interest expense accounted for. All timing differences between this optional treatment and the simple recognition of the rental expenses give rise to deferred tax accounting.

The same rules apply mutatis mutandis for the lessor in its consolidated financial statements.

Greece

In Greece neither the Company Law (L. 2190/1920) nor the General Accounting Plan (Decree 1123/1980) deal with accounting and disclosure requirements regarding lease contracts.

Since 1986 a specific Law (L. 1665/1986) for finance leases is applicable in Greece providing that:

- the rents involved in a finance lease paid by the lessee should be considered as operating expenses deductible from the gross income.

- the lessor is entitled to account for the depreciation on the leased assets as if they had been acquired by the lessee.

- the lessor is entitled to make tax-free allowance for doubtful debts.

- the lessee is entitled to make either tax-free allowance or tax-free reserve for productive investments (article 19 of the law 1892/1990, amended article 6, sections 9 and 10 of the law 1665/1986). These provisions are accounted for on the liability side of the balance sheet.

The law for finance leases addresses only movable assets, it provides for the "sale and leaseback" form of leases, it does not make any distinction between finance leases and operating leases and it does not impose any disclosure requirements for the leases in the financial statements.

Portugal

In Portugal, the Official Chart of Accounts (Plano Oficial de Contabilidade) was recently revised on account of the introduction on Portuguese Law of the provisions of 4th EC Directive, prepared by the regulatory body - the Comissao de Normalizao Contabilistica.

This document makes the distinction between operating and finance leases. The former is treated as expense in the income statement; the latter is treated as an asset and the corresponding liability in the balance sheet, according to the financial plan drawn up, and following the standards issued by IASC (IAS 17). Besides that, the notes to the accounts require the disclosure of the assets treated as finance leases, once they are not specifically indicated in the balance sheet.

Prior to the publication in 1989 of the current Chart of Accounts, the leases were treated as operating leases, or finance leases, according to the tax law which recognises as an expense the expense of a financial lease. This was allowed for a period of 3 years prior to the compulsory implementation of the treatment of the financial leases in the balance sheet.

Spain

1. <u>Operating leases</u>

   General standards for the accounting of operating leases are contained in the General Chart of Accounts (Plan General de Contabilidad)

   a) The Lessee. Shall record the lease payments resulting from the contract as an expense in the accounting period.

   b) The Lessor. The goods or property which are the object of the contract shall figure as balance sheet assets, under tangible fixed assets, and shall be subject to depreciation on their useful life. Lease payments shall be taken to earnings in the accounting period.

2. <u>Finance leases</u>

   According to Spanish legislation (law 26/1988, of 29th July on Discipline and Intervention of Credit Institutions) only financial institutions may provide finance lease contracts, so that accounting standards for the lessor are the ones which the Bank of Spain laid down in its circular 4/1991 of 14th June.

   As regards the lessee, the relevant accounting standards figure in the General Chart of Accounts and have been extended in a Resolution by the Institute of Accounting and Auditing of 21st January 1992.

a) Lessee. The financial lease contract is defined in current legislation as a contract which has the sole object of leasing the use of goods or property acquired for this purpose, according to the specifications of the future user, in return for the receipt of consistent and periodic lease payments. The goods leased shall be utilised for business or professional activities to be undertaken by the user. The contract must include a purchase option in favour of the user when it ends.

For accounting purposes the following should be pointed out :

a1) When the lessee commits himself to exercising or guarantees that he will exercise the purchase option, the goods or property in the contract shall be reported as if they had been acquired by deferred payment. They shall figure in the balance sheet assets, under tangible fixed assets.

a2) When, due to the economic conditions of the contract, there is no reasonable doubt that the purchase option will be exercised, the rights derived from the contract shall figure in the balance sheet assets under a special item included in intangible fixed assets. Rights will be calculated by the value in cash of the goods leased. All payment obligations in the contract, including the value of the purchase option, shall figure under liabilities. The difference between the value FO the rights which figure under assets and the sum of the obligations which appear in liabilities, i.e. the financial charges of the operation, must be disclosed in the balance sheet assets under the item "expenses deferred over various periods", which shall be charged against earnings following a financial criterion.

The lessee shall record as expenses in each accounting period : (a) the depreciation on the rights included in the assets and (b) the financial charges included in the lease payments.

It is understood that there are no reasonable doubts that the purchase option will be exercised when the price of the purchase option is insignificant when compared with the total sum of the contract, or when it is less than the residual value the goods or property are estimated to possess on the date the purchases option may be exercised.

b) Lessor. Goods or property leased under a finance lease will be reflected in din balance sheet assets as a loan receivable for the amount of the lease payments pending, excluding financial charges, plus the value of the purchase option. As the finance lease payments are being settled the financial charges paid by the lessee shall be recorded as income for the accounting period.

3. Disclosure requirements

a) Lessee. Information will be provided on goods or property used under finance leases, indicating: the cost of the goods or property upon acquisition, the price of the purchase options, the duration of the contracts, the number of years elapsed, and the lease payments settled and still pending.

   Any important items existing shall be detailed, providing additional information on their use, expire date and period of depreciation.

b) Lessor. He must provide information on the total amount of the finance lease operations, disclosing the different items on the balance sheet.

United Kingdom

There are no accounting requirements in British law that relate directly to leasing. There are statutory disclosure requirements as follows:

- Paragraph 50 (5) of Schedule 4 (1985 Companies Act) provides that "Particulars shall also be given of any other financial commitments which:

  (a) have not been provided for, and

  (b) are relevant to assessing the company's state of affairs".

In so far as finance leases are capitalised by lessees, the obligations under finance leases are provided for in the accounts. Thus the above requirements will normally only be relevant for operating leases.

- Paragraph 53 (6) of Schedule 4 requires disclosure of the "amount charged to revenue in respect of sums payable in respect of the hire of plant and machinery".

- The balance sheet formats in Schedule 4 require that creditors falling due within one year should be shown separately from creditors falling due after more than one year. The net obligations under finance leases and hire purchase contracts will have to be split accordingly.

- The balance sheet formats in Schedule 4 provide that the "amount falling due after more than one year shall be shown separately for each item included under debtors". This is relevant to the disclosure of amounts receivable by a lessor.

- In addition the Companies Act disclosures about fixed assets and creditors will affect lessees and lessors.

2. Rules issued by other regulatory bodies on lease contracts

Lease contracts are not addressed by other regulatory bodies in the following countries:

- Denmark
- Greece
- Italy
- Portugal

However, in **Italy** the Stock Exchange requires accounts to be prepared by listed companies in accordance with accounting principles set by Consiglio Nazionale dei Dottori Commercialisti or, in their absence, with International Accounting Standards. Which would mean that for leasing IAS 17 applies.

The following gives a summary of the requirements in the countries where leasing is addressed by regulatory or supervisory bodies apart from the law:

Belgium

The "Commission of Accounting Standards" issued recommendations for special cases or explanatory notes to the definitions and gave a very broad interpretation to the accounting definition of finance leasing of movable property.

France

As far as the lessor's consolidated accounts are concerned, instruction no. 86.05 of the Commission Bancaire (which issues mandatory rules for banking institutions) provides for the following:

(article 4, al. 2) "crédit bail" contracts or lease contracts with a purchase option must be capitalised for the amount in the accounts determined by the financial accounting, and not by fiscal, rules. The potential reserve is accounted for among the consolidated reserves, for the amount calculated after deferred taxes.

Germany

With respect to the income tax treatment of lease contracts on movable assets, the Federal Finance Ministry has published a decree which had widespread consequences on the conclusion of such contracts in Germany. The decree sets out standardised schemes for attribution to the lessor or lessee of the economic ownership of the leased asset. One of the consequences of the aforementioned fiscal rules is that - with few exceptions -in Germany there are only lease contracts under which the ownership lies with the lessor. The decree makes a distinction between finance leases and operating leases for immovable and movable goods.

Ireland

The Stock Exchange requires accounts to be prepared in accordance with Standards regarded by the Council as appropriate for companies of international standing and repute. Indications of compliance with this requirement would be accounts prepared, in all material respects, in accordance with international accounting standards or accounting standards as applied in the Republic of Ireland, (for details see United Kingdom).

The Stock Exchange requirements for annual accounts include a requirement that the borrowings should be analysed between amounts repayable:

(i) in one year or less;

(ii) between two and five years;

(iii) in five years or more.

Luxembourg

The following legal provisions concerning leasing operations exist:

a) Law of 27 November 1984 concerning the supervision of the banking sector, art. 1, 3a and Circular no. 83/4 issued by the Institut Monétaire Luxembourgeois (IML).

b) Circulars LAG 37 of 4 January 1974 and LAG 40 of 24 April 1976 issued by the director of the tax administration.

ad b) Tax law:

1) Categories of lease contracts

The tax law makes a distinction between financial lease contracts, operating lease contracts and non-full-pay-out lease contracts.

Financial lease contract: agreement which foresees that the contract cannot be cancelled during a certain period, during which the lessee has paid the entire purchase price of the asset including financial costs (Grand-Ducal decree dated 29.10.1987).

Depending on the terms of the contract, the asset will either be attributed to the lessor or to the lessee (see sub. 2: Attribution of the leased assets).

Operating lease contract: it is considered as an ordinary rental agreement

- the agreement may be cancelled at any moment;
- the risk of increase in value or of the decease in value for economic or/and technical reasons, insurance premiums, repair and maintenance costs of the asset are mainly borne by the lessor.

Non-full-pay-out lease contract: agreement which foresees that the contract may be cancelled after a certain period, during which the lessee will pay only part of the purchase price including financial and other costs.

2) Attribution of the leased assets

Operating lease

In case of an operating lease, the lessor is the legal and the economic owner of the leased asset.

Financial lease

a) If no option is granted to the lessee to purchase the asset at the end of the fixed period foreseen in the contract, the asset will be attributed to the lessor if the fixed period of the contract amounts to at least 40% and not more than 90% of the useful life of the asset.

Otherwise, the asset will be attributed to the lessee, who in that case is considered to be the economical owner of the asset.

b) If an option is granted, the asset will be attributed to the lessor if the fixed period is included between 40% and 90% and provided the price of the option is no lower than the book value of the asset determined over the useful life according to the straight line method.

c) In the case of real estate, the economic ownership is attributed to the lessor, if the following conditions apply:

For those contracts without a purchase or prolongation option:

* Always, in the case of land.
* For buildings, if the base rental period is between 40% and 90% of the useful life f the buildings (which is, as a rule, assumed to be 50 years).

For agreements containing a purchase option:

* If the contract specifies that the building is attributed to the lessor, the land is also attributed to the lessor.
* For buildings only, if the basic rental period is between 40% and 90% of the useful life of the building and the purchase price at the exercise of option is not below book value of the building (applying straight-line method of depreciation) plus book value of the land or, if lower, fair market value of both.

For contracts containing a prolongation option:

* Always in the case of land.
* For buildings, if the base rental period is between 40% and 90% of the useful life of the building and the instalments payable during a prolongation of the contract are higher than 75% of the rent of a comparable property.

Non-full-pay-out lease

For these contracts the attribution of ownership is regulated in the following way:

- If the lessor has a right to sell and the lessee has no purchase option, the asset is attributed to the lessor.

- If the contract provides for the sharing of any capital gain realised upon sale of the asset, the asset is attributed to the lessor if the sales price is less than the residual value of the good and if this difference will have to be paid to the lessee or if in case of a profit, the lessor will receive 25% of the profit and the lessee 75% of the profit. If the profit share of the lessor is less than 25%, the asset is attributed to the lessee.

- If the contract provides that the lessee can cancel the contract after a certain time, under the condition that he will pay to the lessor the difference between the purchase price of the asset minus the lease payments and 90% of the sales price, the asset is attributed to the lessor. The same applies if the sum of the leasing terms and the sales price exceeds the purchase price.

3) Accounting by lessor/lessee

If the economic ownership is attributed to the lessor he must include leased assets at cost in fixed assets and present them in the balance sheet at written down value following the straight-line method of depreciation. The depreciation represents an expense in the profit and loss account, whereas the payments received from the lessee represent income. Proceeds of sale at the termination of the contract are required to be accounted for as extraordinary income. In the books of the lessee, lease payments are fully deductible expenses.

If the economic ownership is attributed to the lessee he must capitalise the asset in his balance sheet at the lessor's purchase value, plus any other acquisition costs, but not including the rental payments. The lessee depreciates the asset over its estimated useful life on a straight-line basis. The counterpart of the acquisition costs represents a liability towards the lessor. The interest portion of the leasing instalments is deductible as a business expense, whereas the capital portion of the instalments is debited against the liability account.

The lessor will book the acquisition cost of the asset as a loan. The interest portion of the lease instalments is treated as income, the remaining portion being the redemption of the loan.

Netherlands

The Dutch Council for Annual Reporting has issued guidelines. Chapter 1.05, paragraphs 121-127, addresses leasing:

"121 A distinction is made between finance leases and operating leases.

122 Finance leasing is in essence a form of financing in which the legal ownership of the assets generally remains with the lender, the economic risks being borne entirely or almost entirely by the borrower.

123 An operating lease achieves very largely the same object as a "huurovereenkomst" (lease) in Netherlands law, namely that the lessee should have the benefit and use of an asset, the economic risks remaining entirely or almost entirely for the lessor's account. Under an operating lease, however, the lessor's obligations in many cases go further than those of a traditional lessor: he usually takes care of the entire maintenance of the assets leased and also arranges for their replacement in the event of their temporary failure.

Operating leases are used mainly for assets for which there is a ready market and for which the trend in value is predictable.

124 Between the two forms discussed in paragraphs 122 and 123 there are a number of intermediate forms. The nature of any specific arrangement will have to be deduced from the terms of the contract as a whole.

125 If it is evident from the terms of the contract as a whole that a finance lease is involved, the assets leased should, notwithstanding paragraph 117, be capitalised. On the basis of paragraph 103, it should be expressed in the balance sheet or in the notes that the legal entity is the economic but not the legal owner.

There will in principle be economic ownership where:

- the lessee will be entitled, during or immediately after the expire of the period for which the lessor has committed himself, to purchase the asset at a price lying substantially below its market value; or
- the lessor has committed himself for a period of approximately the same duration as the economic life of the asset; or
- the lessee has committed himself for a shorter period than the economic life of the asset, but has been granted an option at a considerably lower

rental for the ensuing period up to approximately the end of the economic life of the asset.

The balance sheet procedure will then be the same as that set forth in paragraphs 119 and 120 for hire-purchase.

126 An operating lease can never give rise to the leased items being carried as an asset. But where the legal entity has entered into commitments involving substantial sums of money for rather long periods, this should be disclosed in the notes. (See chapter 2.51, Liabilities in general).

In the case of operating leases, the lessor should carry the leased items in his balance sheet as Tangible fixed assets.

Where a credit institution acts as the lessor under an operating lease, the assets leased may be shown under Debtors.

127 In many types of finance leasing a finance company is involved. The commonest forms are:

1. The supplier sells the assets to the finance company, which leases them to the user.

2. The supplier leases the assets to the user, sells them to the finance company and assigns to the latter the rights and obligations under the lease.

3. The user buys the assets from the supplier and sells them (immediately or subsequently) to the finance company, which then leases them back to the user ("sale and lease-back").

The arrangement is usually one whereby the finance company is the legal owner but runs no risks of ownership.

In such cases the finance company should show the outstanding rentals in its balance sheet under Accounts receivable, not under Fixed assets.

Sometimes the supplier undertakes to indemnify the finance company against losses on such receivables.

Where that is so, the supplier should if necessary make provision for this in his balance sheet."

The Council for Annual Reporting (CAR) incorporates IASs in its guidelines, in so far as CAR is of the opinion that they are acceptable to Dutch accounting practice. The provisions of IAS 17 relating to the additional information to be disclosed in the annual accounts of lessees and lessors have not yet been fully incorporated.

Spain

In 1991 the Bank of Spain laid down specific standards on the accounting of lease contracts (circular 4/1991 of 14th July) for credit Institutions. The regulations referring to operating leases and finance leases from the point of view of the lessee are similar to the general standards in the General Chart of Accounts.

United Kingdom

SSAP 21 "Accounting for leases and hire purchase contracts" was developed by the Accounting Standards Committee (now superseded by the Accounting Standards Board) and issued by each of the six member bodies of the Consultative Committee of Accountancy Bodies.

SSAP 21 requires finance leases to be capitalised by the lessee. Operating leases are to be disclosed. The lessor should account in a consistent way (e.g. not show a finance lease as an asset but as a receivable). A finance lease is one that "transfers substantially all the risks and rewards of ownership of an asset to the lessee". The presumption is that this will be the case where "at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset".

Some extracts from SSAP 21 follow in order to add some detail for the United Kingdom (and Ireland):

"Hire purchase and leasing

31. Those hire purchase contracts which are of a financing nature should be accounted for on a basis similar to that set out below for finance leases. Conversely, other hire purchase contracts should be accounted for on a basis similar to that set out below for operating leases.

Accounting by lessees

32. A finance lease should be recorded in the balance sheet of a lessee as an asset and as an obligation to pay future rentals. 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.

33. In practice in the case of a finance lease 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.

35. Rentals payable should be apportioned between the finance charge and a reduction of the outstanding obligation for future amounts payable. The total finance charge under a finance lease should be allocated to accounting periods during the lease term so as to produce a constant periodic rate of charge on the remaining balance of the obligation for each accounting period, or a reasonable approximation thereto.

36. An asset leased under a finance lease should be depreciated over the shorter of the lease term (as defined in paragraph 19) and its useful life. However, in the case of a hire purchase contract which has the characteristics of a finance lease, the asset should be depreciated over its useful life.

37. The rental under an operating lease should be charged on a straight-line basis over the lease term, even if the payments are not made on such a basis, unless another systematic and rational basis is more appropriate.

Accounting by lessors

38. The amount due from the lessee under a finance lease should be recorded in the balance sheet of a lessor as a debtor at the amount of the net investment in the lease after making provisions for items such as bad and doubtful rentals receivable."

Disclosure requirements in SSAP 21 include (for lessees):

- Gross amounts of assets held under finance leases, with accumulated depreciation. As an alternative this information may be integrated with owned fixed assets. In that case, however, the net amount of assets held under finance leases and the depreciation for the period in respect of those assets included in the overall total should be disclosed;
- Annual depreciation;
- Obligations related to finance leases;
- Annual finance charges;
- Operating lease rentals;
- Accounting policies adopted.

The requirements of SSAP 21 accord very closely with the content of IAS 17.

3. Recommendations on leasing issued by national professional bodies

In the following countries the national professional bodies have not issued any recommendations or rules on leasing contracts:

- Belgium
- Denmark
- France
- Greece
- Italy
- Luxembourg
- Netherlands
- Portugal
- United Kingdom

However, in **Denmark** the Danish State-Authorised Public Accountants Association (abbreviated to FSR in Danish) publishes IASs, and in the foreword to the IAS publications, FSR discusses whether the individual standards reflect the requirements made in Denmark in order that accounting principles become generally accepted. In the foreword to IAS 17 (Accounting for Leases), FSR expresses fundamental agreement with the standard, subject to a few modifications:

"The Danish Presentation of Accounts Act merely mentions the term leasing and does not distinguish between finance leasing and operating leasing. Neither does the law determine whether financial leasing arrangements can be recognised in the balance sheet as fixed assets, as is mentioned in IAS 17. It is FSR's definite impression that the Presentation of Accounts Act does not exclude this possibility. It is also FSR's opinion that in such cases where there is a financial leasing of considerable fixed assets, there should be a choice between treating them in accordance with ° 46, section 3 of the Presentation of Accounts Act or in accordance with the rules of IAS 17."

Furthermore FSR mentions in the preface that the development should not be forced towards capitalisation, but that the development should happen by degrees.

The accounting principles generally accepted in Denmark are based on section 46 (3) of the Danish Company Accounts Act and IAS 17.

FSR is of the opinion, as stated above, that the Company Accounts Act does not exclude the possibility of capitalising assets leased under finance leases. Thus, according to the principles generally accepted, it is possible to employ either the provisions of section 46 (3) of the Company Account Act or the provisions of IAS 17 with respect to assets leased under finance leases. In the event that assets leased under finance leases are capitalised by the lessee, such assets should be recorded as accounts receivable in the lessor's accounts, as prescribed by the standard.

Where the lessee chooses to employ section 46 (3) of the Company Accounts Act, rentals are not to be apportioned between a finance charge and a depreciation charge for the leased asset in the profit and loss account. Where the lessee bases his accounts on IAS 17, rentals are to be apportioned as prescribed by paragraphs 45-46 of IAS 17.

Generally accepted accounting principles for operating leases have come to reflect paragraphs 47 and 51-53 of IAS 17. Thus, the lessor records the leased asset in his balance sheet, and the lessee only records lease payments in his profit and loss account. In the lessor's profit and loss account, rental income is to be recognised on a systematic basis over the lease term, and the depreciation charge for the asset is to be expensed.

FSR expressed agreement with paragraphs 57-62 of IAS 17 regarding disclosure of leased assets, and this must be considered a generally accepted principle.

For the **Netherlands** it should be noted that NIVRA participates in the CAR and does therefore not issue any recommendations on annual reporting itself.

In **Portugal**, the CROC (Camara dos Revisores Oficiais de Contas) as a professional body did not issue any special recommendation on this matter. However they support strongly the principle of substance over form in many other recommendations.

In **Spain** the national professional body (ICJCE) has issued recommendations which are presently under review, in light of the law of December 1990.

In the **United Kingdom** SSAP 21 was developed by the accounting profession (ASC - Accounting Standards Committee). However, the ASC is now replaced by the Accounting Standards Board (ASB) which is a regulatory body independent of the accounting profession. ASB has adopted all SSAPs.

The following gives a summary of the recommendations on leasing issued by national professional bodies.

Germany

Bearing in mind the aforementioned practice of formulating lease contracts in Germany, the Institut der Wirtschaftspruefer published in 1989 a statement on the accounting treatment by the lessor (HFA 1/1989) which sets out detailed provisions for disclosure and valuation of the leased property by the lessor as well as for recognition in income of lease payments, for the required risk provision and for the formulation of lease contracts. This statement has been met with widespread approval by those engaged in accounting.

Ireland

The national professional bodies issued a statement of standard accounting practice n_ 21 "Accounting for leases and hire purchase contracts" in August 1984 (SSAP 21). The requirements of IAS 17 "Accounting for leases" accord very closely with the content of SSAP 21 and accordingly compliance with SSAP 21 will ensure compliance with IAS 17 in all material respects.

4. Definitions

Below, a short description is given of the definitions used in the various countries, the purpose or use of the definition and the source of the definitions. Where applicable the definitions are given for "lease", "finance lease" and "operating lease".

Belgium

The Royal Decret of October 1976 enforced the Law of 17 July 1975 concerning the annual accounts of limited liability companies, defines lease-contracts, making a distinction between finance leases and operational leases. After the latest amendment of this Decret (on 3 December 1993), finance lease-contracts include the following types of contracts:

"1. Long term rights to use immovable property, which the company has by virtue of leasing or similar contracts, in as far as the instalments foreseen in the contract (in addition to interest and ancillary costs) cover the entire capital invested by the lessor in the property. Finance leases in relation to immovable property must thus be "full pay out" contracts.

2. Rights to use movable property, which the company has by virtue of lease contracts and other similar non-cancellable contracts, in as far as the instalments foreseen in the contract, increased by the amount payable if the purchase option is exercised, cover the entire capital invested by the lessor, including interest and ancillary costs."

Amendments (made in 1991) to the Royal Decree allow furthermore, with regard to movable property leases:

- on the one hand, that the amount payable in case the purchase option is exercised should only be taken into account if it represents not more than 15% of the capital invested in the movable property; and

- on the other hand, to assimilate with a purchase option, the possibility for the lessee to continue the contract by making instalment payments for lesser amounts or to assimilate with a purchase option, a sales option with regard to the movable property which the lessor has retained for himself in relation to a third party or to the lessee.

Operational leases are long term contracts that do no not meet the criteria to qualify as a finance lease.

Denmark

Definitions are the definitions used in IAS 17.

France

The French Civil code (articles 1708 and following) defines a lease as follows:

"A lease is a contract under which one of the parties is bound to make available to the other party a specific thing during a period of time, the other party being bound to pay a certain amount of money".

French law makes no general distinction between operating and finance leases. However, a certain type of finance lease, called "crédit-bail" has been defined by the law no. 66-455 dated 2 July 1966".

According to this law:

"Crédit bail" is an operation of leasing of assets, the lessor having bought the leased asset for the only purpose of leasing; the contract of "crédit bail" gives to the lessee the option of purchasing the rented assets for a determined price taking into account the paid rents during the period of contract. The lessor remains the owner until the option is used.

According to this law, "crédit-bail" may be used to finance machinery and equipment, land and buildings used in business, and businesses.

The lessors allowed to enter into "crédit-bail" contracts are specific financial institutions regulated by law. Most of these institutions are subsidiaries of banks.

The purpose of the law on "crédit-bail" was to regulate the practice of finance leases and to provide a legal framework to the users and the financial institutions.

Germany

1. General

   In Germany, the usual differentiation between finance and operating leases is not as important as elsewhere. Instead, the treatment of lease contracts for accounting and tax purposes is based on the concept of economic ownership. A purchase option might give indications as to the economic owner but is not a requirement of a lease contract.

   Economic ownership is defined by the tax authorities as the right to dispose over (use) property legally belonging to another to the exclusion of the legal owner for a period long enough to reduce the value of the equipment to such an amount that the value of the legal right is insignificant. Thus, as civil law does not provide a definition either of a lease contract or of economic ownership every single contract has to be considered individually. As far as finance leases are concerned, the Ministry of Finance has provided by decree a number of rules to achieve a uniform treatment of lease contracts.

   Generally, a contract is considered as a finance lease and the rules mentioned above apply if:

   1. the lease contract may not be terminated during a fixed lease term, and
   2. either the lease contract is a full pay-out contract (that means the instalments paid by the lessee cover the original acquisition price paid by the lessor as well as the financing expenses (see 2)) or the lease contract is a non-pay-out contract (see 3).

   Also, those rules differentiate between the leasing of movable assets, buildings and real estate.

   It should be noted that operating leases are usually treated as normal rent. However, other contracts not mentioned within the rules of the Ministry of Finance may still provide economic ownership by the lessee.

2. Economic ownership under full pay-out contracts

In the case of full pay-out contracts, according to the following provisions, economic ownership is decided as follows:

a) Contract without option

In the case of movable assets and buildings, the lessor is regarded as the economic owner if the basic lease term covers 40-90% of the economic lifetime. If the basic lease term is beyond this period, the lessee is considered as the economic owner. In the case of real estate, the lessor is always regarded as the owner.

b) Contract with purchase option

Where the lessee is in possession of a purchase option, the question of the economic ownership additionally depends on the option price if the basic lease term amounts to 40-90% of the economic lifetime. If the option price is at arm's length or higher, the lessor is supposed to be the owner. Where the option price is less than arm's length, the asset is assigned to the lessee.

Concerning real estate, the classification depends on the classification of the building.

c) Contract with option to extend the lease term

If the basic lease term includes 40-90% of the economic lifetime, the lessor is the owner in the case of movable assets if in the following lease contract the instalments cover at least the remaining depreciation calculated on the remaining book-value or on the fair market value if it is less than the book-value.

Concerning buildings, the instalments of the second lease contract must cover 75% of the instalments at arm's length. In all other cases, the lessee is assumed to be the owner. Real estate is always assigned to the lessor.

d) Special lease

If leased assets may only be used by the lessee, the lessee is deemed to be the economic owner.

3. Economic ownership under non-pay-out contracts

With respect to non-pay-out lease contracts, economic ownership is attributed to one of the contracting parties according to the following rules, also issued by the German Ministry of Finance. It should be noted again that the parties may also choose other types of contracts as shown below.

a) Put-option contracts

If the lease contract provides for a put option in favour of the lessor, economic ownership by the lessee cannot be assumed as he is excluded from an increase in the asset's value.

b) Distribution-of-sales-proceeds contracts

If the asset is sold at the end of the lease term and any profit resulting from the sale is to be distributed amongst the contracting parties, the lessor is deemed to be the owner if he s entitled to claim 25% or more of the realised profit.

c) Final instalment contracts

If the lessee is entitled to terminate the contract after a lease term of at least 40% of the economic lifetime of the asset and obliged to pay a final instalment, the lessor is deemed to be the owner if 90% of the proceeds are charged against the final instalment and the lessor is entitled to claim any remaining gain from the sale, or any difference between his global cost and the sum of the lease payments and the final instalment if this sum is less than the global cost.

Greece

In Greece, leasing is regulated under Law 1665/1986 "Finance lease contracts (Leasing)".

In article 1 of the above mentioned law the definition of finance lease contract is given as follows:

"Article 1 - Definition

1. Under a finance lease contract the lessor (the leasing company as it is described in Article 2) has to convey to the lessee, in return for rent, the right to use the movable asset destined for the enterprise or the profession of the lessee, giving him, at the same time, the option either to purchase the asset or to renew the contract for an agreed period of time. The contracting parties may prescribe that the purchase option may be exercised before the expiration of the contract period.

2. A movable asset which the leasing company (lessor) had previously purchased from the lessee may be the subject of a finance lease between these parties.

The introductory text of the draft law on "Finance lease contracts (Leasing)" gives the following clarification: "The term finance lease has been preferred to any other term referring to financing or credit, to avoid confusion with a bank credit."

Under Law 1665/1986 no distinction is made between finance lease and operating lease. Therefore no specific definitions of these terms are provided under this law.

Italy

For commercial purposes there is no definition of a lease. The commercial law does not deal with lease contracts. Lease contracts are normally classified under other types of contracts. Only fiscal law gives a clear cut definition, which is, however, only valid for fiscal purposes. From the practical point of view standard contracts are used.

Luxembourg

The lease of goods is defined in article 1710 of the civil law as follows:

"The leasing of goods is a contract by which one of the parties binds itself to let the other parties use the goods during a certain period for a certain price which the other party binds itself to pay".

This definition is used in order to determine the legal owner of the leased goods. It is of importance for the determination of registry taxes and VAT.

The definitions of finance lease and operating lease are derived from income tax law and are used for determining the economic owner which is important for income tax purposes and for accounting.

Financial lease contract: agreement which foresees that the contract cannot be cancelled during a certain period, during which the lessee has paid the entire purchase price of the asset including financial costs (Grand-ducal decree dated 29.10.1987).

Operating lease contract: it is considered as an ordinary rental agreement.

- The agreement may be cancelled at any moment.

- The risk or increase in value or of the decrease in value for economic or/and technical reasons, insurance premiums, repair and maintenance costs of the asset are mainly borne by the lessor.

Netherlands

The concept of leasing is clearly defined neither in the law nor in jurisprudence. In the guideline issued by the Dutch Council on Annual Reporting a description rather than a definition is given:

"122 Finance leasing is in essence a form of financing in which the legal ownership of the assets generally remains with the lender, the economic risks being borne entirely or almost entirely by the borrower.

123 An operating lease achieves very largely the same object as a "huurovereenkomst" (lease) in Netherlands law, namely that the lessee should have the benefit and use of an asset, the economic risks remaining entirely or almost entirely for the lessor's account. Under an operating lease, however, the lessor's obligations in many cases go further than those of a traditional lessor: he

usually takes care of the entire maintenance of the assets leased and also arranges for their replacement in the event of their temporary failure. Operating leases are used mainly for assets for which there is a ready market and for which the trend in value is predictable."

Definitions of leasing, finance leases and operating leases currently used in the Netherlands are the definitions given in IAS 17.

For tax purposes there is an agreement, dated February 1987, between the Minister of Finance and the association of lease companies, in which it is agreed under what conditions a lease is qualified as an operating lease. The most important aspect in the agreement is that "the 90%-rule" is used but with different numbers:

- The maximum lease term has to cover 80% of the useful life of the asset.
- The purchase-option at the end of the lease-term is based on the estimated real residual value of the asset, which is not less than 5% of the gross investment.

If no purchase-options are agreed on, the conditions are slightly different. In general the following conditions have to be met:

- Lessee and lessor are not related parties.
- The residual value is not guaranteed by the lessee or by a related party of the lessor. Third parties are allowed to give a guarantee up to 5% of the gross investment.

Portugal

Definitions are the definitions used in IAS 17.

Spain

There is no specific definition of a finance lease. Under the accounting rules currently in force (Plan General de Contabilidad, parte quinta: Normas de valoraçion), in the section dealing with intangibles (statement 5, point F), precise rules on lessee accounting are laid down only in the case of lease contracts where, based on the economic terms and conditions, there is no reasonable doubt that the purchase option will be exercised.

The "Plan General de Contabilidad" was approved by Royal Decree (Real Decreto 1643/90) on 20 December 1990 and published in the Official Bulletin (Boletin Oficial del Estado) on 27 December to be effective from 1 January 1991.

Further details on accounting for lease-contracts by lessors are now laid down in Circular 4/1991 of the Bank of Spain.

United Kingdom and Ireland

SSAP 21 "Accounting for leases and hire purchase contracts" defines the terms as follows:

14. A lease is a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. The term "lease" as used in this statement also applies to other arrangements in which one party retains ownership of an asset but conveys the right to the use of the asset to another party for an agreed period of time in return for specified payments.

15. A finance lease is a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments, including any initial payment, 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 (as defined in paragraph 24). If the fair value of the asset is not determinable, an estimate thereof should be used.

16. Notwithstanding the fact that a lease meets the conditions in paragraph 15, the presumption that it should be classified as a finance lease may in exceptional circumstances be rebutted if it can be clearly demonstrated that the lease in question does not transfer substantially all the risks and rewards of ownership (other than legal title) to the lessee. Correspondingly, the presumption that a lease which fails to meet the conditions in paragraph 15 is not a finance lease may in exceptional circumstances be rebutted.

17. An operating lease is a lease other than a finance lease.

5. Practice

The following summarises per country how leases are accounted for in practice.

Belgium

The rules mentioned in section 1 are imposed by law. Another accounting practice is not allowed for the balance sheet and the income statement. It is permitted to disclose more than imposed by law, but there is no information available if this is really the case, and if so, to what extent and what the contents may be of the complementary information. If more disclosure is given than legally imposed it will be of a heterogeneous nature.

Denmark

The generally accepted accounting principles as described in part 3 are followed. Disclosure must be made, as mentioned previously, of the maximum capitalised commitment or the annual rental payable, as well as the term of the lease. In addition FSR considers it a generally accepted principle to make disclosure of leased assets, significant renewal and purchase options, contingent rentals, etc. (paragraph 59 of IAS 17).

France

In practice, enterprises comply with the disclosure requirement (as per section 1). Indeed, this requirement is accompanied by a penal sanction.

About 50% of the main companies use the legal option applying to the consolidated accounts (capitalisation). That option is especially used by enterprises that comply with international standards in their consolidated accounts (IAS or US standards), in so far as the amounts are material enough. They are well-known, and generally big groups: BSN, Carrefour, Moët Henessy, Peugeot, Rhône Poulenc, Saint-Gobain, etc.

Germany

Lease contracts in Germany almost exclusively imply that the economic ownership lies with the lessor. As regards the accounting treatment for the leased property, he has to apply the principles set out in Statement HFA 1/1989 published by the Institut der Wirtschaftspruefer.

In addition to the disclosure requirement as per ° 285 n_ 2 of the German Commercial Code the rules set out in Section D 6 of the Statement HFA 1/1989 gain special importance. They deal with material start-up losses or close-down profits resulting from lease contracts in cases where the scope of business is considerably modified.

A survey of the 1987 annual financial statements of 100 large public companies shows that 89 out of these 100 companies disclosed the total amount of other financial commitments whereby 64 companies have gone beyond the legal requirement and indicated the relevant amounts for the commitments mentioned. In these cases the rental and leasing commitments were predominant. As regards the remaining 25 companies, they only indicated the total amount, but this amount consisted almost exclusively of commitments resulting from rental and lease contracts and consequently most probably a breakdown did not prove necessary.

Empirical data on the disclosure of start-up losses or close-down profits are not yet available since the statement of the Main Technical Committee only came into force in 1989.

Greece

In practice as well as in the Greek law and the Greek General Accounting Plan, there is no distinction between finance leases and operating leases as far as the accounting and disclosure treatment suitable for them is concerned.

In practice the accounting for leases in the financial statements and the disclosure requirements are as follows:

a) from the point of the lessee.

- The leased assets with their nominal value are included in memo accounts (debit accounts-credit accounts) of the balance sheet, together with other items as off-balance sheet items;

- The rents involved in a lease are included as operating expenses in the financial statements together with other items.

b) from the point of the lessor

- The leased assets either are shown separately from other assets in the balance sheet or are disclosed in the notes to the balance sheet;
- There is no distinction between finance leases and operating leases in the balance sheet;
- The leased assets are depreciated over their useful life on a straight line basis, according to the decree 88/1973 concerning the depreciation of fixed assets;
- The rents are treated as income on accrual basis and they are shown in the profit and loss account together with other items (e.g. turnover: rents and commissions).

Ireland

Practice usually follows the requirements of SSAP 21 and the Companies (Amendment) Act.

Italy

Accounting for leasing in Italy is heavily influenced by tax law, as leasing has only been regulated for fiscal purposes. The fiscal law states that the leased assets should be included in the accounts of the lessor, i.e. the historical value of assets is inscribed in the balance sheet and the sum of the annual rent proceeds in the profit and loss account. The lessee includes the annual rent expenses in the profit and loss account.

Luxembourg

One of the principles of the tax law is that the tax law follows the accounting rules unless the tax law provides for other rules. Regarding lease contracts, as no specific accounting rules exist in Luxembourg, the tax law is usually followed for accounting purposes.

Disclosure is limited. However, in many cases, the obligations linked to lease contracts are disclosed in the note covering off-balance sheet items.

Netherlands

In general, leases are accounted for and disclosed in the financial statements on the basis of the legal obligations and the CAR-guidelines. The extent of the disclosures does not exceed the obligations and guidelines mentioned. The above can be summarised in the following table:

	Operating lease	Finance leases
By lessor	as an asset	Asset as annuity-loan
By lessee	in the notes	Assets capitalised in balance sheet at fair value (purchase price calculation or value on basis of lease payments and interest rate). Debt is stated as an annuity-loan

Portugal

In practice and until 1992 the leases are, in general, treated as operating leases, due to the benefits to the undertakings. The disclosure in the financial statements is normally very poor.

There is a conflict between accountants and tax authorities about accounting for lease contracts. According to the standards issued by the Portuguese standard-setting body, the "Comissao de Normaliza_ao Contabilistica", the accounting for leases should comply with IAS 17, but the tax authorities allow tax benefits to those who account for leases as rents as far as they accept them as tax expenses. So, in spite of the Portuguese Official Chart of Accounts, prepared by CNC and issued as a decree-law, most undertakings account for the lease contracts as rents. However, the Camara dos Revisores Oficiais de Contas recommends to its members that the most advisable method is that indicated by CNC and IASC in order to give a "true and fair view" (or "image fidèle").

Spain

No disclosures on leases were made in the accounts with year-end on or before 31 December 1989. As the law has come into force only in December 1990, there is so far no experience with the new requirements.

United Kingdom

The requirements of SSAP 21 and the Companies Act are generally adhered to. However, the 90% test detailed in SSAP 21 appears to be used in practice as a rule rather than as a guide.

Companies listed on the London Stock Exchange and quoted on the USM have to give additional information in respect of their borrowings. Otherwise there are no distinctions between companies.

ANNEX II

DEFINITIONS

Below, the definitions set out in paragraph 4 of the main text are given in alphabetical order.

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

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

Finance charge: the amount borne by the lessee over the lease term, representing the difference between the total of the minimum lease payments (including any residual amounts guaranteed by him) and the amount at which he records the leased item of property at the inception of the lease.

Finance lease: a lease that transfers substantially all the risks and rewards incident to ownership of an item of property. Title may or may not be transferred at the end of the lease. Paragraph 9 provides some criteria on the interpretation of "substantially all".

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

Inception of the lease: the earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.

Interest rate implicit in the lease: the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments, from the standpoint of the lessor, and (b) the unguaranteed residual value to be equal to the fair value of the leased item of property.

Lease: an agreement whereby the lessor conveys to the lessee in return for rent the right to use an item of property for an agreed period of time.

Lease term: the non-cancellable period for which the lessee has contracted to lease the item of property together with any further terms for which the lessee has the option to continue to lease the item of property, with or without further payments, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Lessee's incremental borrowing rate of interest: the rate of interest that, at the inception of the lease, the lessee would incur to borrow over a similar term and with a similar security the funds necessary to purchase the leased item of property.

Minimum lease payments: the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with, to the extent that it is likely that the amounts guaranteed will be paid or received:

(a) in the case of the lessee, any amounts guaranteed by him or by a party related to him; or

(b) in the case of the lessor, any residual value guaranteed to him by either the lessee or a party related to the lessee or an independent third party financially capable of meeting this guarantee.

However, if the lessee has the option to purchase the item of property at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable and if, at the inception of the lease, it is reasonably certain that the option will be exercised, the minimum lease payments comprise the minimum rentals payable over the lease term and the payment required to exercise this purchase option.

Net cash investment: the balance of the cash outflows and inflows in respect of the lease excluding flows relating to insurance, maintenance and similar costs rechargeable to the lessee. The cash outflows include payments made to acquire the item of property, tax payments, interest and principal on third party financing.

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

Non-cancellable lease: a lease that is cancellable only: (a) upon the occurrence of some remote contingency, (b) with the permission of the lessor, (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor, or (d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Operating lease: a lease other than a finance lease.

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

Unguaranteed residual value: that portion of the residual value of the leased item of property (estimated at the inception of the lease), the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Useful life: is either (a) the period over which a depreciable asset is expected to be used by the enterprise; or (b) the number of production or similar units expected to be obtained from the asset by the enterprise.

ANNEX III

EXAMPLES OF PROBLEMS IN LEASE ACCOUNTING IN PRACTICE

In practice a number of problems in accounting for leases have arisen, which may not immediately be evident from the main text. Examples of these problems are set out below.

Example I - Accounting for residual values

Company A enters into a lease agreement to lease computer equipment with customer C. The lease agreement specifies payments which amount to a full payout over 3 years but at the end of the 3 year lease period the computer equipment must be returned to A. The lease payments amount to £480,000 over the 3 years.

A then sells the benefit of the lease to a finance house F for a lump sum of £460,000. The sale, however, only relates to the benefits of the lease payments; A retains all rights to the computer equipment at the end of the lease term.

A uses the sales proceeds of £460,000 to buy the computer equipment and succeeds in obtaining this for £450,000. It therefore records a profit of £10,000 at the outset. This is uncontroversial.

A also, however, record as a profit at the outset the present value of the future benefit of the computer. The residual value of the computer equipment at the end of the 3 year lease period is estimated at £45,000 and the present value at the outset is therefore £22,000. Accordingly the company records a total initial profit of £32,000.

Example II - Lease classification

Many problems arise in lease classification where the terms are such that the lessor records the lease as a finance lease whilst the customer treats it as an operating lease on the basis of different perceptions of a fixed substantial percentage. The 90% is only used as an example of a fixed percentage so as to illustrate the danger of using a threshold mechanically. Where there is a real third party guarantee this is uncontroversial but often the lease is structured as a 90% pay back lease. This means that the lessor calculates the present value of future lease receivables as being more than 90% of original cost and the customer calculates the payback as being less than 90%. This can arise in many ways: e.g.

i Different discounting rates are used by the two parties.

ii The lessee does not know the real initial cost and assumes a different fair value.

iii The contract includes an early termination clause which is unlikely to be taken up.

In practice many leases rely on residual values which are unguaranteed but safe. This is the case of a car fleet where the lease is structured as an operating lease for the lessee by having the lessor assume the risk on residual values. However in practice these risks are minimal because the lessee is obliged to make up any shortfall below an agreed amount. That amount will be sufficiently low that it is highly unlikely that a supplementary payment will be needed. The lessor accounts for the lease as a finance lease; the customer accounts for it as an operating lease.

Example III - Sale and leaseback transactions

Some sale and leaseback transactions have been structured in a way as to convert unrealised gains into realised gains. Consider the following example:

Company X has a freehold building in its accounts at an amount representing cost less accumulated depreciation of £ 100,000. X then enters into a sale and leaseback transaction whereby the company "sells" the building for £400,000 with a leaseback over 3 years at rentals equivalent to a discounted amount of £400,000 over the 3 years with the option to purchase at the end of the 3 year period at a nominal sum.

Accounting standards suggest that since there has in substance been no disposal there has been no profit on the sale. However the apparent profit is brought into income over the lease period. The effect is to bring an unrealised gain into distributable income over the lease period.

Example IV - Contingent rentals

Many rental contracts are linked to a cost of living index. In classifying leases and in recognising income there can be problems if no account is taken of the expected rise in the index.

These are just some of the areas where a different view might be taken from those of Member States.

European Commission

Paper on the Accounting Advisory Forum – Accounting for lease contracts

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