

Case 11-6

Lessee Ltd.

Lessee Ltd., a British company that applies IFRSs, leased equipment from Lessor Inc. on January 1, 2013, for a period of three years. Lease payments of \$100,000 are due to Lessor Inc. each year. Other expenses (e.g., insurance, taxes, maintenance) are also to be paid by Lessee Ltd. and amount to \$2,000 per year. The lessor did not incur any initial direct costs. The lease contains no purchase or renewal options and the equipment reverts back to Lessor Inc. on the expiration of the lease. The remaining useful life of the equipment is four years. The fair value of the equipment at lease inception is \$265,000. Lessee Ltd. has guaranteed \$20,000 as the residual value at the end of the lease term. The \$20,000 represents the expected value of the leased equipment to the lessee at the end of the lease term. The salvage value of the equipment is expected to be \$2,000 after the end of its economic life. The lessee's incremental borrowing rate is 11 percent (Lessor's implicit rate is 10 percent and is calculable by the lessee from the lease agreement).

The junior accountant of Lessee Ltd. analyzed the assets under lease, determined whether the lease was an operating lease or capital lease, and prepared the applicable journal entries. The senior accountant of Lessee Ltd. reviewed the junior accountant's analysis and prepared a separate analysis. As the finance controller, you were given both analysis to determine the correct accounting treatment. Calculations and journal entries performed by your junior and senior accountant are below.

Present Value of the Lease Obligation

Using the rate implicit in the lease (10 percent), the present value of the guaranteed residual value would be \$15,026 ($\$20,000 \times 0.7513$), and the present value of the annual payments would be \$248,690 ($\$100,000 \times 2.4869$).

Using the incremental borrowing rate (11 percent), the present value of the guaranteed residual value would be \$14,624 ($\$20,000 \times 0.7312$), and the present value of the annual payments would be \$244,370 ($\$100,000 \times 2.4437$).

Junior accountant analysis:

Since the equipment reverts back to Lessor Inc., it is an operating lease.

Entries to be posted in Years 1, 2, and 3:

Dr. Lease expense	\$100,000	
Dr. Insurance expense	\$2,000	
Cr. Cash		\$102,000

(Operating lease rental paid to Lessor Inc.)

Senior accountant analysis:

Step 1 — Lease classification

The lease term is for three years. The useful life of the equipment is four years. Since the lease term is for a major part of the useful life of the equipment, it is a finance lease.

Step 2 — Computation of the lease asset and obligation

Since the lessee's incremental borrowing rate is greater than the lessor's implicit rate in the lease, compute the present value of the minimum lease payments using the 11 percent rate.

Present value of the minimum lease payments = $\$100,000 \times 2.4437 = \$244,370$.

Step 3 — Allocation of payments between interest and lease obligation

Since interest has to be charged on the straight-line method, the following is the allocation of the interest and the reduction in the lease liability.

Year	Cash Payment	Interest Expense (11%)	Reduction in Lease Obligation	Balance of Lease Obligation
	\$	\$	\$	\$
0				244,370
1	100,000	26,881	73,119	171,251
2	100,000	26,881	73,119	98,131
3	100,000	26,881	73,119	25,012

Journal entry in Year 1 to record the payments:

Dr. Rent expense	\$2,000	
Dr. Interest expense	\$26,881	
Dr. Lease obligation	\$73,119	
Cr. Cash		\$102,000

Required:

1. Was the junior accountant's analysis correct? Why or why not?
2. Was the senior accountant's analysis correct? Why or why not?
3. How would the answer differ under U.S. GAAP?