Circular No. 21/2019

CONSULTING

ACCOUNTING TREATMENT OF LEASE AGREEMENTS WITH A PURCHASE OPTION

Barcelona, 21 November 2019

SUMMARY

The key factors of **finance leases** (more often referred to as "leases with a purchase option") are discussed below. We will go over the **requirements** that must be met for a lease to be regarded as a finance lease, as well as the **different cases tha**t arise and how they should be treated for **accounting purposes**.

BACKGROUND

Lease agreements with a purchase option are contracts whereby a lessor grants the right to use a fixed asset to a lessee, for which the lessee pays a number of instalments over a specific term. When the agreement expires, the lessee has the option of purchasing the leased asset. Leases of this type take the form of **a lease agreement that includes a purchase option** that may be exercised within the **contractually stipulated term**.

REGULATORY CONTEXT

The accounting treatment of leases is regulated in **Recognition and Measurement Standard (RMS) 8 of the Spanish Chart of Accounts** which stipulates that a lease should be classed as a finance lease (with a purchase option) "when it may be deduced from the **economic conditions** of a lease agreement that **substantially all the risks and rewards inherent to the ownership of the asset concerned are transferred**".

It adds that in a lease agreement with a purchase option it will be assumed that said transfer of risks and rewards exists **when there are no reasonable doubts that said option will be exercised, that is, the final purchase of the asset**.

From an accounting point of view[1], the above **reasonableness requirement** when **exercising the purchase option will be met if**:

- **The fair value** of the asset at the date on which the option is exercised **significantly exceeds** the **price agreed to transfer the asset**, which has to be evaluated by the directors.
- In this respect, **the above situation may be assumed** to occur when the **price agreed for the transfer of the asset is equivalent to the fair value of the asset** on the date the lease agreement is signed **less the monthly payments** made by the lessee prior to the exercising of the option.

PRICE OF PURCHASE OPTION = (Fair value of the leased asset − Monthly payments)

Therefore, and in line with the above, if there are no reasonable doubts about the exercising of the purchase option, the **lease agreement should be accounted for as a finance lease** in accordance with RMS 8 of the Spanish Chart of Accounts.

In the event that there are **reasonable doubts as to the exercising of the option**, the lease **will be classed as an operating lease**. In this case, the lessor will recognise revenue for the income accrued and the lessee will recognise a lease expense for said payments.

ACCOUNTING TREATMENT

- The **lessor**[2], will recognise a **receivable for the present value of the minimum payments** to be received for the lease **plus the asset's residual value**, **discounted at the implicit contract interest rate**. Likewise, the result of the operation will be accounted for by derecognising **the asset subject to the financial lease at its net book value**.

[1] Ruling request 6 of BOICAC 99/2014
[2] Ruling request 5 of BOICAC 78/2009

	DEBIT	CREDIT
(252) long-term loans	X	
(521) short-term loans	X	
(2) leased tangible asset		X
(6) o (7) profit or loss on disposal of fixed assets	Complete this table in case of losses.	Complete this table in case of earnings.

- The **lessee** must **recognise the value of the leased item under assets** and must simultaneously recognise the amount payable to the lessor **under liabilities on the balance sheet**.

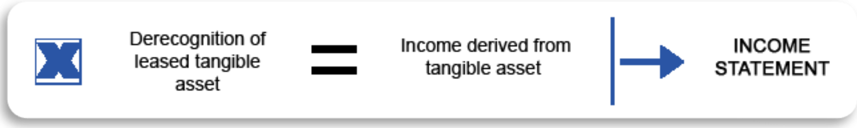
	DEBIT	CREDIT
(174) Creditors long-term finance lease		X
(524) Creditors short-term finance lease		X
(2) leased tangible asset	X	

In the event that the lease is classed as a finance lease but **finally the purchase option is not exercised by the lessee**:

- From an accounting viewpoint this situation would imply an **adjustment to the carrying value** of assets and/or liabilities resulting from the obtainment of additional information or knowledge of new events which, under RMS 22 of the Spanish Chart of Accounts, would be **classified as a change in accounting estimates**.

  Changes in accounting estimates are applied on a prospective basis and the relevant effect is attributed, depending on the nature of the transaction concerned, **as income or expense in the income statement for the year** or, when appropriate, is charged directly against equity.
  Specifically:

  - The **lessee** must record the derecognition of the tangible asset subject to the lease with a purchase option at its carrying value, and must derecognise the outstanding liability with the lessor, recording the relevant income derived from the tangible asset.



- <u>The **lessor**</u> must recognise the addition of the leased asset at its acquisition cost on the date of finalisation of the term for exercising the purchase option, equivalent to the outstanding receivable held against the lessee. In this event, no income will be recorded in the income statement.

The professionals in our **Consulting Area** that **specialise in company finance and accounting** are at your disposal for any clarification or additional information you may require in relation to the content of this circular letter. Please contact us by telephone at **934 677 414**.

Yours faithfully,

AUDICONSULTORES
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