

Treasurer's Instruction No	502
Title	Leases
Effective date	1 November 2005
Objective and Background	Provides instruction and guidance in respect of the classification of leases
Last Reviewed Date	1 November 2005

This Instruction was previously known as Treasurer's Instruction No 1016 – Leases.

Black letter (or bold) items within these Instructions are mandatory and other plain font items are instructional or for the purpose of providing guidance only.

BACKGROUND

A lease is an agreement granting one party (the lessee) the right to use, for a specified period of time, an asset owned by another party (the lessor), in return for a series of payments of rental by the user of the asset. Items that can be leased include infrastructure, motor vehicles, information technology and office equipment.

For accounting purposes, leases are classified as either finance leases or operating leases.

CLASSIFICATION OF LEASES

- (1) The Head of Agency shall ensure that the agency does not enter into a finance lease as defined by Australian Accounting Standard AASB 117 *Leases*.**

The classification of a lease as an operating lease or a finance lease depends upon its economic substance.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. A lease is classified as an operating lease if substantially all the risks and rewards incidental to ownership remain with the lessor.

The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from the use of the asset and gains in realisable value.

A finance lease is a form of borrowing. Only the Treasurer has the authority to borrow funds on behalf of the State. No other Minister or Head of Agency has the legislative authority to borrow funds, enter into finance lease agreements, or enter into any contract that involves the Agency in the borrowing of funds or guarantees borrowings by other parties.

Accordingly, agencies are only permitted to enter into operating leases.

Chart 1 *Classification of a Lease* (below) provides guidance on the accounting classification of lease arrangements. A lease that meets the following criteria will be classified as an operating lease:

- (a) the lease must be a cancellable lease; and
- (b) the lease term must be less than 75 per cent of the remaining economic benefit of the leased asset; and
- (c) the present value at the beginning of the lease term of the minimum lease payments must be less than 90 per cent of the fair value of the leased asset at the inception of the lease.

Where a lease contains a bargain purchase option, the amount payable on the exercise of that option forms part of the minimum lease payments.

Any implied terms or arrangements should be considered when determining the economic substance of a lease. For example, although a lease, or a sale and leaseback, may comprise only a minor portion of an asset's economic life, the asset may be so essential that the lessee could not operate effectively without it. This implies either that the lease will be renewed or that the lessee will gain ownership of the asset, thus leading to classification of the lease as a finance lease

Cancellable

Whether a lease is cancellable or non cancellable establishes the lessee's right to uninterrupted use of the asset during the lease term. A cancellable lease is a lease which:

- does not require the permission of the lessor, and is not dependent upon the occurrence of some remote contingency to be cancelled;
- on cancellation, does not commit the lessee to enter into a further lease for the same, or equivalent, asset with the same lessor or a third party related to the lessor; or
- does not include a penalty of a magnitude that, in normal circumstances, could be expected to discourage cancellation.

Lease term

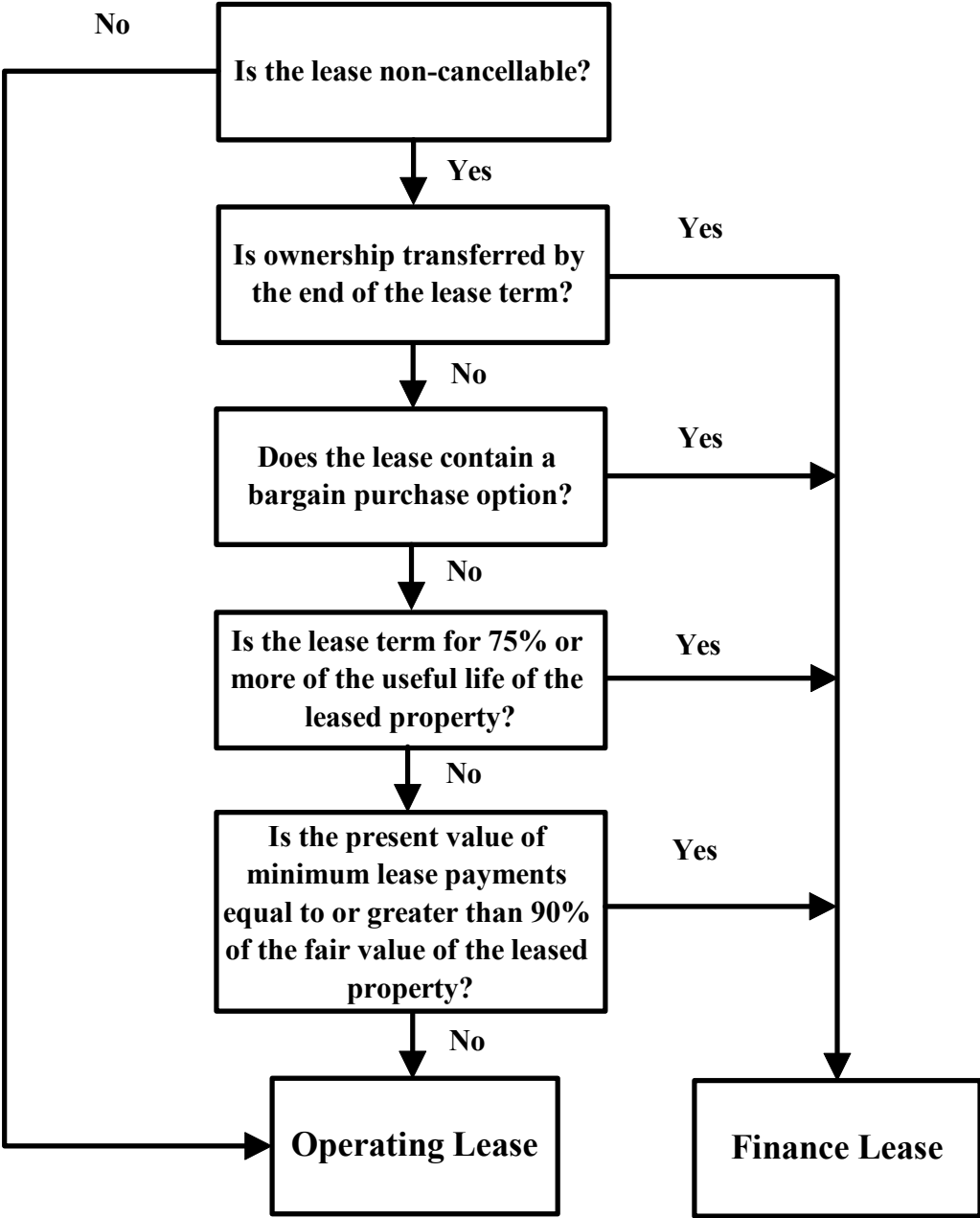
Lease term means:

- the period of the lease; and
- any period of renewal of the lease flowing from an option, express or implied, which allows the lessee to renew the lease for a rental which, in relation to the expected fair rental of the asset at the date the option becomes exercisable, is low enough to make renewal of the lease appear, at the inception of the lease, to be reasonably assured.

The useful life relates to the estimated remaining economic life of the leased asset with no dependence on the lease term.

Where a lease term commences within the last 25 per cent of the total useful life of the property the lease term criterion may become distorted in the later years of an asset's life, and should not be applied.

Chart 1 Classification of a lease



PURCHASE OR LEASE

- (2) The Head of Agency shall undertake a detailed internal appraisal of the costs and benefits of purchasing versus leasing an asset before entering into an operating lease.**

The decision whether to lease or purchase an asset should be based upon a Business Case. The Business Case is developed to:

- gain approval to proceed with the asset acquisition;
- obtain resourcing for the asset acquisition; and
- document what the acquisition of the asset will accomplish and how this will be achieved.

The Business Case may relate solely to the asset acquisition or reflect a larger project of which the asset acquisition forms part. The Business Case should compare the cost of leasing with the cost of purchase. This may involve undertaking a Net Present Value analysis of the cash flows associated with each alternative. Leasing enables an agency to spread the cost of an asset over its useful life rather than as an upfront initial outlay.

Leasing also ensures that the lessor, as owner, bears the cost of changes in technology. This may be particularly important with information technology and other types of technical equipment.

The recommended methodology for use in preparing a Business Case is available at www.projectmanagement.tas.gov.au.

Whether purchasing or leasing an asset, an agency must comply with the Procurement requirements as set out in Part XI Procurement and Disposal.