

**Statement of
Financial Accounting Standards
No. 2**

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Translated by

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Leases

I Introduction

- (1) This Statement establishes the accounting standards for leases.
- (2) A lease contract involves at least two parties and property that is being leased. The lessor owns the property and receives periodic rent in exchange for allowing the lessee to use it.

II Definitions

- (3) The definitions of the key terms used in this Statement are listed below:
 - (a) *Inception date of the lease*: The date on which: (i) the leased property or the bill of lading for the leased property has been transferred to the lessee; and (ii) the periodic rent commences. If the lease contract specifies an inception date other than the date defined above, both the lessor and lessee should follow the contract.
 - (b) *Bargain purchase option*: An option allowing the lessee to purchase the leased property for a price that is sufficiently lower than the expected market value of the property at the exercise date of the option. The exercise of the option must appear to be reasonably assured at the inception date of the lease.

- (c) *Bargain renewal option*: An option allowing the lessee to renew the lease for a rental that is sufficiently lower than the expected market rental of the property at the exercise date of the option. The exercise of the option must appear to be reasonably assured at the inception date of the lease.
- (d) *Lease term*: The fixed noncancelable term of the lease plus periods covered by the bargain renewal option and before the exercise date of a bargain purchase option.
- (e) *Unguaranteed residual value*: The part of the estimated residual value retained by the lessor at the end of the lease term that is not guaranteed by the lessee or any third party.
- (f) *Executory costs*: All the costs or expenses required to execute a lease contract, including insurance, property tax, and maintenance.
- (g) *Lease payment receivable*: The lessor's rental revenues plus the bargain purchase price or the estimated residual value at the end of the lease term.
- (h) *Lessor's net investment in leased property*: The difference between the lease payment receivable and the unrealized interest revenue.
- (i) *Lessor's interest rate implicit in the lease*: The interest rate that makes the present value of the lease payment receivable to be equal to the market value of the leased property at the lease inception date. This is also the lessor's required rate of return from the lease.
- (j) *Unrealized interest revenue*: The unrealized part of the lessor's interest receivable (determined by the lessor's interest rate implicit in a capital lease) and service charge.
- (k) *Sales-type lease*: A capital lease which generates manufacturers or dealers profit or loss. That is, a lease in which the present

value of the lease payment receivable (ie, the market value or the selling price of the leased property) is greater or smaller than the cost or carrying value of the leased property, if different.

- (l) *Direct financing lease*: Any type of capital lease other than a sales-type lease.

III Types of leases

- (4) A lease can be classified as either an *operating* lease or a *capital* lease.

Operating leases

- (5) An operating lease is a lease that can not be classified as a capital lease.

Capital leases

- (6) To be qualified as a capital lease for the *lessee*, a lease contract must satisfy any one of the following four criteria:
 - (a) the lease transfers ownership of the leased property to the lessee by the end of the lease term;
 - (b) the lease contains a bargain purchase option;
 - (c) the lease term is equal to 75% or more of the total estimated economic life of the leased property. This criterion should not be applied to leases in which the leased property has been used for more than 75% of its estimated economic life before the lease begins.
 - (d) the present value of the rental payments plus the bargain

purchase price or the guaranteed residual value is at least 90% of the market value (less any investment credits) of the leased property at the inception date of the lease. This criterion should not be applied to leases in which the leased property has been used for more than 75% of its estimated economic life before the lease begins.

- (7) To be qualified as a capital lease for the *lessor*, a lease contract must satisfy any one of the above four criteria plus both of the following criteria:
- (a) collectibility of the lease payment receivables is reasonably assured; and
 - (b) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

IV Accounting standards

Operating leases - lessee

- (8) For a lease contract with rent and a guarantee deposit, the periodic rent should be expensed at the time when it is paid. All accrued or unexpired rent should be adjusted at the end of the lessee's accounting period. The lessee should establish a *Guarantee deposit-out* account for the payment, reimbursement, or rent-deduction of the deposit.
- (9) If the lessee pays only the deposit but does not pay any periodic rent, or if the periodic rent is apparently lower than the market rent, and the lessee actually pays for the leased property using the interest accrued from the deposit then the lessee, at the end of each lease period or the termination of the lease, should calculate the imputed interest using a bank's long-term interest rate and recognize the

amounts in both the *Rent expense* and *Interest revenue* accounts. The payment or reimbursement of the deposit should be debited or credited to the *Guarantee deposit-out* account.

- (10) The *Guarantee deposit-out* account should be classified as either a current asset or other asset, depending on its expiration date.
- (11) The lessee should disclose the following information in the financial statements:
- (a) type of leased property;
 - (b) terms and restrictions in the lease contract; and
 - (c) the calculation of periodic rent, the method of rental payment, and the annual rent payable over the following 5 years. If the lease term is longer than 5 years, the lessee should also disclose the present value and the total rental payments for every 5 years beginning from the sixth year.

Operating leases - lessor

- (12) If a lessor's major business includes the leasing of property, then the lessor may establish a *Leased assets* account for leased property. The lessor should also recognize expenses such as depreciation, maintenance, tax, and insurance relating to the leased property. Any significant modifications and/or additions which may increase the value of the leased property or lengthen the useful life of the leased property should be capitalized.
- (13) The lessor should establish a *Rent revenue* account and a *Guarantee deposit-in* account for the collection and receipt of rental payments and lessee's deposit. The accrued rent or uncollected rent should be adjusted using the *Unearned rent* or *Rents receivable* accounts.
- (14) If the lessor receives only the deposit but does not collect any periodic rent, or if the periodic rent is apparently lower than the market rent, the lessor actually uses the interest accrued from the

deposit as the rent, then, the lessor, at the end of each lease period or the termination of the lease, should calculate the imputed interest using a bank's long-term interest rate and recognize both the rent revenue and interest expense. The receipt or return of the deposit should be credited or debited to the *Guarantee deposit-in* account.

- (15) The *Guarantee deposit-in* account should be classified as either a current liability or other liability, depending on its expiration date.
- (16) The lessor should disclose the following information in the financial statements:
- (a) type of leased property, its cost, and the accumulated depreciation;
 - (b) main lease terms; and
 - (c) the calculation of periodic rent, the method of rent collection, and the annual rent receivable over the following 5 years. If the lease term is longer than 5 years, the lessor should also disclose the present value and the total rent receivable for every 5 years beginning from the sixth year.

Capital leases - lessee

- (17) To the lessee, a capital lease is equivalent to purchasing property using long-term debt or by installment financing. Therefore, the lessee should capitalize the leased property as an asset and recognize the lease liability.
- (18) The value of the leased property is the smaller of the following two values: (a) the present value of all future rental payments (less the lessee's executory costs) plus the bargain purchase price or lessee's guaranteed residual value, and (b) the leased property's market value at the inception date of the lease.
- (19) If the leased property does not have a market value, then the leased property should be valued by calculating the present value of all

future rental payments (less the lessee's executory costs) plus the bargain purchase price or the lessee's guaranteed residual value.

- (20) Leased property should be classified as a fixed asset in the lessee's balance sheet using the *Leased asset* account. The lease liability should be classified as either a current liability or long-term liability (depending on the expiration date) using the *Liability under capital lease* account. If a capital lease involves a deposit, then the accounting principles for an operating lease should be followed.
- (21) All leased property should be depreciated. If the lease contract contains a bargain purchase option or allows the transfer of ownership at the end of the term, then the depreciation should be determined based on the leased property's useful economic life. The lease term is used otherwise.
- (22) The lessee's periodic rental payment is composed of two parts: (i) the purchase of the leased property, and (ii) the interest expense due to long-term or installment financing. Therefore, the lessee should recognize both a lease liability and interest expense in each period. The interest expense is determined using the following rules:
- (a) If the value of the leased property is determined using the *maximum borrowing rate* for non-financial institutions (determined by the Republic of China Ministry of Finance, Department of Treasury) on the inception date of the lease, then the interest expense is equal to the beginning balance of the lease payable times the maximum borrowing rate.
 - (b) If the value of the leased property is determined by its market price, then the interest expense is still equal to the beginning balance of the lease payable times the maximum borrowing rate. However, a service charge should be calculated by multiplying the beginning balance of the lease payable by the difference between the lessor's interest rate implicit in the lease and the maximum borrowing rate.

If there is any unguaranteed residual value at the end of the lease

term, the lessee should calculate the imputed interest expense based on the rental payments, guaranteed residual value, and the leased property's market value using the rules described in the above two paragraphs.

The lessee's lease payable is determined by subtracting the interest expense and the service charge from the periodic rental payment.

- (23) At the end of the lease term, if the lessee promises to return the leased property and guarantees a residual value, the lessee should debit all remaining lease payable and the accumulated depreciation of the leased property, and credit the leased property. If the lessor sells the leased property at a price which is lower than the guaranteed residual value, then the lessee should pay the difference by debiting the *Leased asset disposal loss* account and crediting the *Cash* account.
- (24) After obtaining the leased property at the end of the lease term, the lessor should consider the nature of the leased property and classify it and its accumulated depreciation into the appropriate fixed asset account.
- (25) The lessee should disclose the following information in the financial statements:
- (a) the terms of the lease contract, including the calculations of the rental payments, any bargain renewal or purchase options, and restrictions on the leased property;
 - (b) the total value of all leased property and future lease payables. If the lease term exceeds 5 years, then the lessee should also disclose the total lease payable and its present value for every 5 years beginning from the sixth year;
 - (c) the determination of the value of the leased property, the lease payables, and the depreciation; and
 - (d) if the lessee, at the inception date of the lease, has paid all rent

using checks or notes, the lessee should disclose the total rent paid.

- (26) For capital leases which existed prior to the issuance of this Statement but were accounted for as operating leases, the lessee should change the accounting principle by recognizing the *Lease asset* and *Lease payable* accounts. The leased property should also be depreciated. An adjustment is required to the beginning balance of the retained earnings for any tax effect resulting from the change in accounting principle.

If the lessee provided comparative financial statements, then the statements in the prior year may be re-stated. Any tax effect due to the above adjustment should be treated as deferred income tax and be allocated in future periods.

Lessee's sales and lease back

- (27) If the lessee sells his or her property to the lessor and immediately leases it back, then the overall transaction is called *sales-leaseback*.

The gain or loss resulting from the sale of leased property should be deferred using the *Unearned gain or loss on sales-leaseback* account. If the fair value of the leased property is smaller than its book value, then the lessee should recognize the difference between the fair value and the book value as a loss.

The amortization of the unearned gain or loss on sales-leaseback depends on the nature of the lease. For operating leases, the unearned gain or loss should be amortized using the lease term. For capital leases, however, the unearned gain or loss should be amortized based on rules described in paragraph 21 of this Statement.

- (28) The amortization of the unearned gain or loss on sales-leaseback should be charged to either the *Depreciation expense* account or *Rent expense* account, depending on the nature of the lease.

Capital leases - lessor

(29) For the lessor, a capital lease can be divided into two types:

- (a) *Direct financing lease.* For this type of capital lease, the lessor only recognizes interest revenue on the lease payment receivable. There is no sales profit at the inception date of lease because the cost (or carrying value) of the leased property is the same as its market price. The lease payment receivable (which is the lessor's gross investment in the leased property) is equal to the minimum lease payments plus unguaranteed residual value. The difference between the lease payment receivable and the cost (or carrying value) of the leased property is the unearned interest revenue. The lease payment receivable should be classified as either a current asset or long-term lease payment receivable, depending on the rent collection periods. Unearned interest revenue should be treated as a contra account of the lease payment receivable.
- (b) *Sales-type lease.* This type of lease is called a sales-type lease because the lessor recognizes revenue at the inception date of the lease in the same manner as for regular sales. For a sales-type lease, the lessor recognizes two types of revenues:
- (i) at the inception date of the lease, sales revenue and cost of goods sold are recognized, resulting in the manufacturer or dealer's profit or loss; and
 - (ii) as rental payments are collected, interest revenue on the lease payment receivable is recognized.

The lease payment receivable is equal to the minimum lease payments plus unguaranteed residual value. The cost of goods sold can be calculated by subtracting the present value of the unguaranteed residual value from the cost (or carrying value) of the leased property.

- (30) If the price of the leased property is determined by the lessee and the lessor does not pay any fees for inspection or tests, then the lessor's net investment at the inception date of the lease is equal to the cost of the leased property. The lease payment receivable is equal to the rental payments (calculated based on the lessor's interest rate implicit in the lease) plus bargain purchase option (or estimated residual value). No journal entry is necessary for the collection of unexpired rental payments.
- (31) When collecting the rental payments, the lessor should debit the *Cash* and *Unearned interest revenue* accounts and credit the *Lease payment receivable*, *Interest revenue* and *Service charge* accounts. The interest revenue is equal to the lessor net investment times the maximum borrowing rate for non-financial institutions specified by the Republic of China Ministry of Finance, Department of Treasury. The service charge is equal to the lessor net investment times the difference between the maximum borrowing rate and the interest rate implicit in the lease.
- (32) For a sales-type lease, the lessor should recognize both sales revenue and cost of goods sold at the inception date of the lease. The sales revenue is equal to the selling price minus the present value of the unguaranteed residual value, while the cost of goods sold is equal to the cost of the leased property minus the present value of the unguaranteed residual value. The difference between the selling price and the total lease payment receivable is the unearned interest revenue. The collection of rental payments and the amortization of interest revenue should follow the rules described in paragraph 31.
- (33) At the end of the lease term, when the lessor transfers the ownership of the leased property to the lessee, the lessor should recognize the receipt of cash from the bargain purchase option and eliminate the lease payment receivable.
- (34) The lessor should estimate the possible bad debt expenses and recognize an allowance for doubtful accounts.
- (35) The lessor should disclose the following information in the financial

statements:

- (a) total lease payments receivable and the estimated allowance for doubtful accounts;
 - (b) short-term or long-term unearned interest revenue, which should be a deduction from the lease payments receivable; and
 - (c) unguaranteed residual value.
- (36) If a lessor's capital lease has expired before the issuance of this Statement, then the lessor should change the accounting principles using the following procedures:
- (a) Eliminate all unamortized losses from the sale of leased property by debiting *Retained earnings* (if the leased property was sold in prior years) or crediting *Extraordinary loss* (if the leased property was sold in the current year).
 - (b) If there is any income tax effect due to the above (a) adjustment, these effects should be treated as deferred income taxes and amortized in future years.
 - (c) If the *Retained earnings* account has a debit balance due to the allocation of dividends in prior years or capitalization, then the lessor should transfer capital reserved by law or additional paid-in capital to retained earnings. If the *Retained earnings* account still has a debit balance, then the lessor should cover the debit balance using the net income in future years or the stock capital.
- (37) For those capital leases which have not expired after the issuance of this Statement, the lessor can have the following two options:
- (a) Follow the provisions specified in the original lease. At the end of the lease term, however, the lessor should calculate and recognize the gain or loss from the disposal of the leased

property. Any increase or decrease in income tax should be treated as deferred income tax.

- (b) Follow the accounting principles described in this Statement. The leased property and its accumulated depreciation should be replaced by the lease payments receivable and unearned interest revenue. The beginning retained earnings should also be adjusted and the resulting changes in income tax should be recognized as deferred income tax.

Termination and modification of lease contract - lessee

- (38) If the terms in a capital lease are modified but the nature of the lease remains unchanged, then the lessee should use the original interest rate to recalculate the rental payments and the present value of the bargain purchase price or the guaranteed residual value using the remaining period. The lessee should also adjust the *Leased assets* and *Lease payable* accounts.
- (39) If a capital lease is modified to that of an operating lease, then the lessee should debit the *Lease payable* account and credit the *Leased assets* account and its *Accumulated depreciation* account. A gain or loss from lease modification is recognized in the period of modification for any difference.
- (40) If a capital lease is terminated before the lease term, then the lessee should debit the *Lease payable* account and credit the *Leased assets* account and its *Accumulated depreciation* account. A gain or loss is recognized in the period of termination for any difference.

Termination and modification of lease contract - lessor

- (41) If the terms in a capital lease are modified but the nature of the lease remains unchanged, then the lessor should recalculate the new balance of the lease payment receivable. The difference between the new balance and the original balance should be treated as unearned interest revenue. No adjustment is necessary if the modification of

the lease increases residual value.

- (42) If a capital lease is modified to that of an operating lease, then the lessor should debit both the *Leased asset* and *Unearned interest revenue* accounts and credit the *Lease payment receivable* account. The leased property is valued by its market value or book value (if market value is not available). A gain or loss from lease modification is recognized in the period of modification for any difference.
- (43) At the date of termination, the lessor should reclassify the leased property as leased assets. The determination of its value should follow that set out in paragraph 42.

V Notes

- (44) This Statement was issued on October 1, 1982, and became effective to all publicly-held companies from December 31, 1982. This Statement became effective to all non-publicly-held companies from January 1, 1984.
- (45) This Statement was revised on October 18, 1984.

The provisions of this Statement need not be applied to immaterial items.