I. ACCOUNTING FOR LEASES

A. Accounting for Operating Leases

1. Operating leases are rental agreements. All cash flows must be recognized on a straight-line basis over the lease period as periodic expense to the lessee and as lease revenue to the lessor (matching principle). Cash payments intended to be returned to the lessee are excluded from the expense/revenue calculation and are treated as deposits.

2. Leasehold improvements by a lessee must be expensed over the shorter of the remaining lease term or the life of the improvement.

B. Capital (Finance) Leases and Lessees

1. Under U.S. GAAP, lessees account for capital leases as a purchase of the leased equipment if one or more of four (OWNs) tests is met:
   a. Ownership transfers to lessee at end of lease
   b. Written bargain purchase option exists (purchase option < estimated fair value)
   c. Ninety percent of the leased property's fair value is less than or equal to the present value of the minimum lease payments
   d. Seventy-five percent of the asset's economic life will be consumed in the lease term.

2. Under IFRS, a lease is accounted for as a finance lease if the lease transfers substantially all the risks and rewards of ownership to the lessee.

3. Lessees record the capital (finance) lease asset and the lease liability at the present value of the minimum lease payments, not to exceed the fair value of the asset. Under IFRS, initial direct costs are added to the amount recognized as a finance lease asset.

4. Minimum lease payments include the required periodic payments and the bargain purchase and/or guaranteed residual value (if any). Executory costs (maintenance, insurance, taxes, etc.) are excluded.

5. The interest rate used is the lesser of the rate implicit in the lease (if known) or the lessee's incremental borrowing rate. The lease liability is amortized using the effective interest method.

6. Depreciation is based on the lease term unless the lessee will own the leased asset after the lease term (i.e., the lease has a bargain purchase option or ownership transfers to the lessee at end of the term), in which case the asset life is used for depreciation.
C. Capital (Finance) Leases and Lessor
   1. Under U.S. GAAP, lessors with capital leases classify the leases as sales-type or direct-financing leases. These classification terms are not used for finance leases under IFRS. Under IFRS, a sales-type lease is referred to as a finance lease of an asset by a manufacturer or dealer lessor and a direct financing lease is referred to simply as a finance lease.
   2. Under U.S. GAAP, lessors have capital leases when meeting one of the four OWNS tests as described for lessees above, plus there can be no material uncertainties about collectibility or unreimbursable costs. Under IFRS, a lessor classifies a lease as a finance lease if the lease transfers substantially all the risks and rewards of ownership to the lessee.
   3. Sales-type (finance) leases recognize a dealer profit or gross margin at lease inception. As payments are received, interest revenue is also recognized by the effective interest method.
   4. In a direct-financing type (finance) lease, the lessor acts essentially as a finance company and does not recognize gross profit on sale. Interest revenue is recognized by the effective interest method.

D. Sales and Leasebacks
   1. Under U.S. GAAP, gains are recognized based on the rights retained to the use of the leaseback property:
      a. If the seller/lessee retains substantially all (> 90 percent) of the rights, any gain is deferred over the life of the leased asset.
      b. "Minor" (< 10 percent) retention allows full recognition of any gain when the sale of the asset is recorded.
      c. Mid-range rights retention (10 to 90 percent) requires that any gain be deferred up to the present value of the minimum lease payments (operating lease) or capitalized asset (capital lease), with any excess gain recognized immediately.
   2. Under IFRS, gains are recognized based on the classification of the lease as a finance lease or an operating lease.
      a. If the lease is classified as a finance lease, then all gains are deferred and amortized over the lease term.
      b. If the lease is classified as an operating lease, gains are recognized based on the relationship between the asset's carrying amount, fair value, and selling price. If the sales price of the asset equals fair value (general rule), gains are recognized immediately (no deferral).

II. LONG-TERM LIABILITIES AND BONDS PAYABLE
A. Bonds are long-term debt instruments issued by an entity. Debentures are unsecured bonds. Bonds also may be convertible into common stock and may have detachable warrants. Typically, the face value of individual bonds is $1,000. Interest at the coupon rate may be payable annually or semiannually and bond prices are quoted as 100s (percentage of face value). The market will adjust the price paid for the bond to reflect the market, or effective, interest rate.
B. Bond selling price is the sum of the present value of the total face value of the bond plus the present value of future interest payments, both discounted at the effective (market) interest rate. When the bond coupon rate exceeds the market rate, the bond will sell at a premium. If the bond coupon rate is below the market, the market will adjust and the bond will sell at a discount.

C. Bonds can be issued for more or less than their face amounts. If sold above the 100 face value, the excess is premium. If sold below 100, the difference is discount. Premium and discount result from market interest rate fluctuation between the time the bond is printed and when it is actually issued, and they are amortized to interest expense using the straight-line or effective interest method. (U.S. GAAP allows the straight-line method if the difference between the two methods is immaterial. IFRS requires the effective interest method.) Unamortized discount or premium is a component of the carrying value of a bond. Carrying value is face value at the maturity of the bond, and it is used to calculate the interest expense when using the effective interest method of premium/discount amortization.

D. Under U.S. GAAP and IFRS, bond issuance costs are deducted from the carrying value of the liability and amortized using the effective interest method.

E. When bonds are issued between interest payment dates, the selling price includes the accrued interest to date.

F. Interest is accrued at year-end from the last interest payment date.

G. Convertible bondholders have the option of converting the bonds into common equity. Under U.S. GAAP, the conversion feature is not separately recognized when convertible bonds are issued. The two accounting methods for conversion are book value (U.S. GAAP) and market value. The market value method can result in a gain or loss on conversion, but is not U.S. GAAP. Under IFRS, the bond (liability) and conversion feature (equity) are recognized separately when convertible bonds are issued (similar to the accounting for bonds with detachable warrants).

H. Detachable stock purchase warrants have a value separate from the bond and the value of the warrants is part of stockholders’ equity. The warrants only or market value method may be used to allocate the selling price of the bond plus warrants to the bonds and the warrants.

I. Extinguishment of debt before maturity can result in a gain or loss reported in income from continuing operations.