

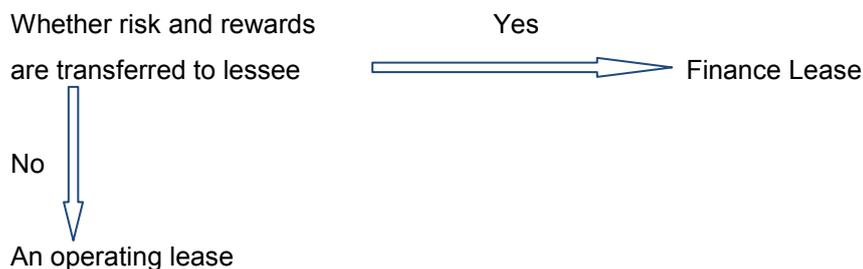
Leases – LKAS 17

1.1 A Lease

A lease is an agreement where by the lessor conveys to the lessee in return for a payment or services of payment to the right to use an asset for an agreed period of time.

1.2 Classification of Leases

For accounting purposes, all leases are classified into one of two categories, either 'finance leases' or 'operating leases'. The classification of leases is based on the extent to which the risks and rewards incidental to the ownership of the leased asset lie with the lessor or the lessee. Rewards are represented by the revenue or cost savings resulting from the use of asset over its economic life and the gains from increases in value of the asset or realization of residual value whilst risk include the repair and maintenance, insurance costs, losses from idle capacity or technological obsolescence.



Following are the examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable (normally *at the end of lease term*).
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialized nature that only the lessee can use them without major modifications.

In addition, following indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual accrue to the lessee; and
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

However, these examples and indicators stated above are not always conclusive.

1.3 Accounting for Finance Leases

(a) Accounting for Finance Leases in the Financial Statements of Lessee

In substance, where a lessee enters a finance lease arrangement, it is essentially the same as acquiring an asset by way of a long-term loan.

Initial Recognition

The lessee will record an asset (a leased asset) and a leased liability. The asset and liability will be recorded at the fair value of the leased asset or, if *lower*, at the present value (PV) of the minimum lease payments (MLP). Minimum lease payments are the payments over the lease term that the lessee required to make together with the amount guaranteed by the lessor. The discount rate to be used in calculating the PV of the MLP is the interest rate implicit in the lease, if it is practicable to

determine, if not the lessee's incremental borrowing rate is to be used.

Initial direct costs

Initial direct costs are defined as incremental costs that are directly attributable to negotiating and arranging a lease. They would include commission, legal fees and costs of preparing and processing documentation for new leases. LKAS 17 requires that a lessee capitalise their initial direct costs that relate to a finance lease as part of the cost of the leased asset.

Measurement subsequent to recognition

Over the term of the lease, the rental payments to the lessor constitute a payment of principal plus finance charge, and the lessee should apportion each payment between the two. The finance charge should be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. The finance charge is calculated by applying the interest rate implicit in the lease to the outstanding leased liability at the beginning of the period. The balance of the payment is considered a reduction of the principal of the lease liability.

Depreciation of leased asset

A leased asset should be depreciated using the depreciation methods normally followed by the lessee in relation to the assets that are owned. Where there is reasonable assurance at the inception of the lease that the lessee will obtain ownership of the asset at the end of the lease term, the asset should be depreciated over its useful life; otherwise, the asset should be depreciated over the shorter of useful life or lease term.

Example 01

A lessee enters into a finance lease agreement on 1 April 2015 for a equipment costing Rs.47, 456. The lease requires a down payment of Rs.13,610 and three annual rental of Rs.13, 610 payable in arrears starting from 31 March 2016. The implicit interest rate of the lease is 10%. The lessee believes that the equipment will last for four years and there is no scrap value at the end of that period. The lessee depreciates assets of this type using the straight-line basis

Discount factor

| Year | DF @ 10% |
|------|----------|
| 1 | 0.909 |
| 2 | 0.826 |
| 3 | 0.751 |

Required

- Provide the journal entries to record the transactions in the lessee's books of accounts
- Provide the extracts from profit or loss for the year ended 31 March 2016 and Statement of Financial Position as at 31 March 2016.

Answer

Initial Recognition

Lower of

| | |
|------------|--------|
| Fair value | 47,456 |
| PV of MLP | 47,456 |

PV of Minimum lease period (MLP) calculation

| Period | Cash flow | Discount Factor | |
|--------|-----------|-----------------|--------|
| 0 | 13610 | 1.000 | 13,610 |
| 1 | 13610 | 0.909 | 12,373 |
| 2 | 13610 | 0.826 | 11,248 |
| 3 | 13610 | 0.751 | 10,225 |
| | | | 47,456 |

| Leased Amortization Schedule | | | | |
|------------------------------|-----------------------------------|------------------------|-------------|-----------------------------|
| Lease Period | Leased liability at the beginning | Interest Expense @ 10% | Rental | Leased liability at the end |
| 1 | 33,846.00 | 3,384.60 | (13,610.00) | 23,620.60 |
| 2 | 23,620.60 | 2,362.06 | (13,610.00) | 12,372.66 |
| 3 | 12,372.66 | 1,237.27 | (13,610.00) | - |

| | | | |
|--|----|----------|----------|
| Leased Asset A/C | Dr | 47,456 | |
| Leased Liability A/c | Cr | | 47,456 |
| (Recording of Leased Asset and Liability at the PV of MLP) | | | |
| Leased Liability A/C | Dr | 13,610 | |
| Cash A/c | Cr | | 13,610 |
| (Payment of down payment) | | | |
| Interest Expense | Dr | 3,384.60 | |
| Leased Liability A/c | Cr | | 3,384.60 |
| (Allocation of finance charge) | | | |
| Leased Liability A/C | Dr | 13,610 | |
| Cash A/c | Cr | | 13,610 |
| (Rental payment) | | | |
| Depreciation | Dr | 11,864 | |
| Accumulated Depreciation A/c | Cr | | 11,864 |
| (Record depreciation) | | | |

| Extracts from Statement of Profit or Loss for the year ended 31 March 2016 | |
|--|-----------|
| Depreciation | (11864) |
| Interest expenses | (3384.60) |

| Extracts from Statement of Financial Position as at 31 March 2016 | | | |
|---|--------|--------------------------|-----------------|
| Non-Current Assets | Cost | Accumulated Depreciation | Carrying Amount |
| Equipment | 47,456 | 11,864 | 35,592 |
| | | | |
| Non-Current Liabilities | | | |
| Leased Liability | | | 12,372.66 |
| Current Liabilities | | | |
| Leased Liability* | | | 11,247.94 |

*At the reporting date, the leased liability should be classified as current liabilities and non-current liabilities. The current liability should be what is expected to be settled in the next reporting period. At the reporting date (31 March 2016) it is derived from deducting the non-current leased liability from the total liability (23620.60-12372.66= 11247.94). This can be easily taken from the lease amortization schedule.

(b) Accounting for Finance Leases in the Financial Statements of Lessor

Initial Recognition

The lease receivable is recorded at the net investment. Net investment is 'the gross investment in the lease discounted at the interest rate implicit in the lease'. LKAS 17 defines the 'gross investment in the lease' as the aggregate of:

- a) the minimum lease payments receivable by the lessor under a finance lease and
- b) any unguaranteed residual value accruing to the lessor (proportion of the residual value of the leased asset guaranteed by a party related to the lessor).

At the inception of the lease, the lessor might incur initial direct costs. Such costs include commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. Under a direct-finance lease, the initial direct costs are included in the finance lease receivables.

Measurement subsequent to recognition

The interest to be earned by the lessor over the lease term will be represented by the difference between the fair value of the leased asset and the sum of the undiscounted minimum lease payments and any unguaranteed residual value. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. Consistent with the interest expense for the lessee, the interest revenue for the lessor is determined by multiplying the opening present value of the lease receivable by the interest rate implicit in the lease.

Example 02

A lessee enters into a leasing agreement on 1 April 2015 for a piece of equipment costing Rs.47, 456. The lease requires a down payment of Rs.13,610 and three annual rental of Rs.13, 610 payable in arrears starting from 31 March 2016. The implicit interest rate of the lease is 10%. The lessee believes that the equipment will last for four years and will have no scrap value at the end of that period. The lessee depreciates assets of this type using the straight-line basis. Both the lessee and the lessor have accounting periods ending on 31 March.

Discount factor table

| Year | DF @10% |
|------|---------|
| 1 | 0.909 |
| 2 | 0.826 |
| 3 | 0.751 |

Required

- Provide the journal entries to record the transactions in the lessor's books of accounts
- Provide the extracts from profit or loss for the year ended 31 March 2016 and Statement of Financial Position as at 31 March 2016.

Answer

Initial recognition at net investment

| | |
|-----------|--------|
| PV of MLP | 47,456 |
|-----------|--------|

PV of gross investment calculation

| Period | Cash flow | Discount Factor | Discounted Cash Flow |
|--------|-----------|-----------------|----------------------|
| 0 | 13610 | 1.000 | 13,610 |
| 1 | 13610 | 0.909 | 12,373 |
| 2 | 13610 | 0.826 | 11,248 |
| 3 | 13610 | 0.751 | 10,225 |
| | | | 47,456 |

Leased Amortization Schedule

| Lease Period | Leased receivables at the beginning | Interest Income @ 10% | Rental | Leased receivables at the end |
|--------------|-------------------------------------|-----------------------|-------------|-------------------------------|
| 1 | 33,846.00 | 3,384.60 | (13,610.00) | 23,620.60 |
| 2 | 23,620.60 | 2,362.06 | (13,610.00) | 12,372.66 |
| 3 | 12,372.66 | 1,237.27 | (13,610.00) | - |

| Journal Entries | | | |
|--|----|----------|----------|
| Leased Receivables A/C | Dr | 47,456 | |
| Cash A/c | Cr | | 47,456 |
| (Recording of Leased Asset at the PV of MLP) | | | |
| Cash A/c A/C | Dr | 13,610 | |
| Leased Receivables A/C | Cr | | 13,610 |
| (Receipt of down payment) | | | |
| Leased Receivables A/C | Dr | 3,384.60 | |
| Interest Income | Cr | | 3,384.60 |
| (Allocation of finance income) | | | |
| Cash A/c | Dr | 13,610 | |
| Leased Receivables A/C | Cr | | 13,610 |
| (Receipt of rental) | | | |

| Extracts from Statement of Profit or Loss for the year ended 31 March 2016 | |
|---|----------|
| Interest Income | 3,384.60 |

| Extracts from Statement of Financial Position as at 31 March 2016 | |
|--|-----------|
| Non-Current Assets | |
| Leased Receivables | 12,372.66 |
| | |
| Current Asset | |
| Leased Receivables* | 11,247.94 |

*At the reporting date, the leased Receivables should be classified as current asset and non-current asset. The current asset should be what is expected to be received in the next reporting period. At the reporting date (31 March 2016) it is derived from deducting the non-current leased asset from the total asset ($23,620.60 - 12,372.66 = 11,247.94$). This can be easily taken from the lease amortization schedule.

1.4 Accounting for Operating Leases

(a) Accounting for Operating Leases in the Financial Statements of Lessee

Lessee should handover asset to the lessee after the lease period. Therefore there is no ownership to the lessee. Eg : Taking an asset on rental basis. Lease payments are recognised as an expenses over the lease period.

Example 4

On 1 January 2015 ABC PLC entered in to an operating lease agreement with PQR PLC for the lease of machinery.

| | |
|--------------------------|-------------------------------------|
| The lease period | 3 years |
| Annual lease installment | Rs.120,000 (Payable on 31 December) |

Required:

Provide the journal entries to record the transactions in books of lessee

| | | |
|--|---------|---------|
| Operating lease expense Dr | 120,000 | |
| Cash Cr | | 120,000 |
| (Recognition of operating lease expenses on machinery) | | |

(b) Accounting for Operating Leases in the Financial Statements of Lessor

Where a lease is classified as an operating lease, the leased property subject to the lease is requirements as a non-current asset. LKAS 17 states that 'lessors shall present assets subject to operating leases in their statements of financial position according to the nature of the asset'. That is, the lessor effectively retains control of the asset under an operating lease and, therefore, should disclose the asset that has been leased to another party. Further, if the asset is depreciable, the lessor involved in an operating lease is required to depreciate the asset.

Lease income from operating lease should be recognized in income on straight-line basis over the lease term, unless another basis is more representative of the time pattern in which benefits derived from the leased asset is diminished. Initial direct costs incurred in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognized as an expense over the lease term on the basis as the lease income.

1.5 Sale and Leaseback Transaction

These transactions involve the original owner of an asset selling it to a provider of finance and immediately leasing it back. These parties will be termed as seller/lessee (the original owner) and buyer/lessor (the finance provider). Sale and leaseback transactions are fairly a common feature of a number of industries (e.g. retail and hotel industries), where it is an accepted form of financing. The accounting treatment of the transaction by the seller/lessee depends on the type of the lease involved - i.e. whether the leaseback is under is a finance lease or an operating lease.

1.6 Disclosures

Finance leases (lessees)

- a) For each class of asset, carrying amount at the end of the reporting period
- b) Reconciliation between the total of future minimum lease payments at the end of the reporting period and their present value.
- c) General description of the lessee's material leasing arrangements
- d) Requirements for disclosure in accordance with LKAS 16, LKAS 36, LKAS 38 apply to lessees for assets leased under finance leases

Finance leases (lessors)

- a) Reconciliation between the gross investment in the lease at the end of the reporting period and the present value of minimum lease payment receivable at the end of the reporting period
- b) Unearned finance income
- c) Unguaranteed residual values accruing to the benefit of the lessor
- d) General description of the lessor's material leasing arrangements

Operating leases (lessees)

- a) Total of future minimum lease payments
- b) Lease and sublease payments recognized as an expense in the period
- c) General description of the lessee's significant leasing arrangements

Operating leases (lessors)

- a) Total of future minimum lease payments
- b) General description of the lessor's significant leasing arrangements