SLFRS 16 - Leasing

SLFRS 16 requires **lessees** to **recognise most leases on their balance sheets.**

- Lessees will have a **single accounting model for all leases,** with **two exemptions** (low value assets and short term leases).
- **Lessor accounting** is substantially **unchanged.**
- There will be **additional disclosure** requirements.
- The new standard will be **effective** from **1 January 2019**

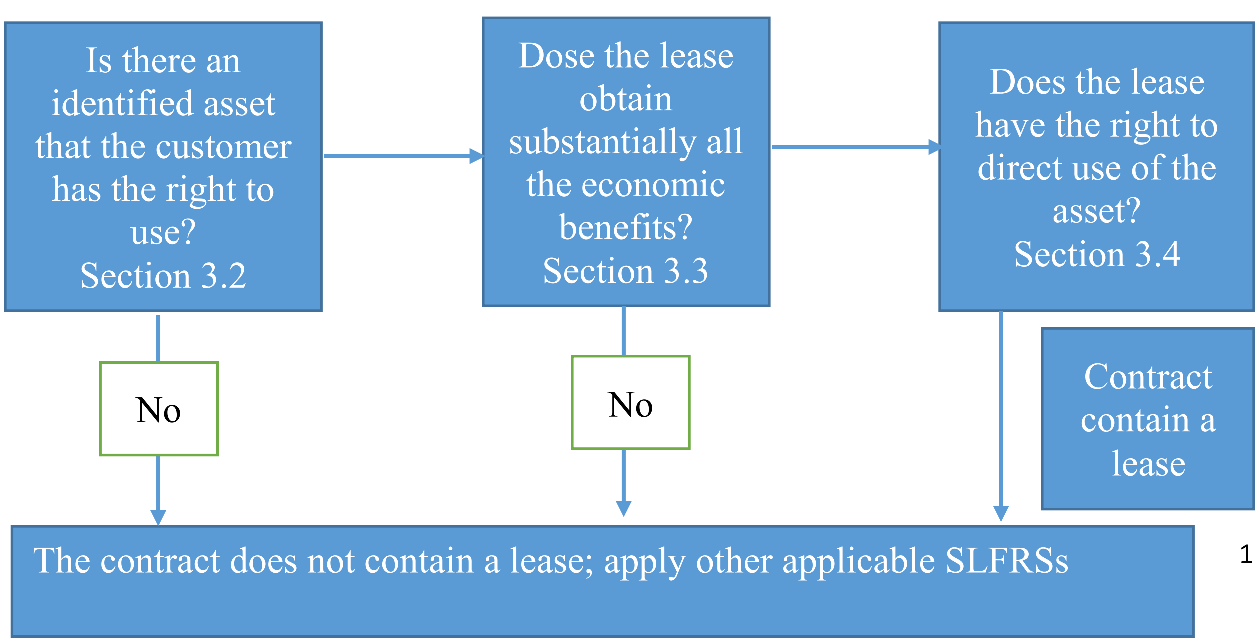
Determining whether an arrangement contains a lease

Under the new standard, a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

To be a lease, a contract must convey the right to control the use of an identified asset, which could be a physically distinct portion of an asset such as a floor of a building.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to:

- obtain substantially all of the economic benefits from the use of the identified asset; and
- direct the use of the identified asset (i.e., direct how and for what purpose the asset is used).



Identifying and separating lease and non-lease components of a contract and allocating contract consideration.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (i.e., non-lease components such as maintenance). For these contracts, the non-lease components are identified and accounted for separately from the lease component, except lessees can make an accounting policy election, by class of underlying asset, to account for both components as a single lease component.

Lessees that do not make this policy election are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessors are required to apply SLFRS 15 to allocate the consideration in the contract.

Lessee accounting
Initial recognition and measurement

Lessees are required to initially recognise a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term.

The lease liability is measured at the present value of the lease payments to be made over the lease term.

Lease term
An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

Lease payments

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

a) fixed payments (including in-substance fixed payments), less any lease incentives;
b) variable lease payments that depend on an index or a rate;
c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Discount Rate.

For the purpose of discounting rate should be decided as follows.

- Rate implicit in the lease if readily determinable
- Otherwise incremental borrowing rate

Right of use the Asset.

- The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives
- received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Subsequent measurement.

Lessees accrete the lease liability to reflect interest and reduce the liability to reflect lease payments made. The related right-of-use asset is depreciated in accordance with the depreciation requirements of LKAS 16 Property, Plant and Equipment.

For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease.

Lessees remeasure the lease liability upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate), which is generally recognised as an adjustment to the right-of-use asset.

Lessees apply alternative subsequent measurement bases for the right-of-use asset under certain circumstances in accordance with LKAS 16 and LKAS 40 Investment Property. Right-of-use assets are subject to impairment testing under LKAS 36 Impairment of Assets.

Presentation

Right-of-use assets are either presented separately from other assets on the balance sheet or disclosed separately in the notes.

Similarly, lease liabilities are either presented separately from other liabilities on the balance sheet or disclosed separately in the notes.

Depreciation expense and interest expense cannot be combined in the income statement. In the cash flow statement, principal payments on the lease liability are presented within financing activities; interest payments are presented based on an accounting policy election in accordance with LKAS 7 *Statement of Cash Flows*.

Lessor accounting

Initial recognition and measurement.

The accounting by lessors under the new standard is substantially unchanged from today's accounting in LKAS 17.

Lessors classify all leases using the same classification principle as in LKAS 17 and distinguish between two types of leases: operating and finance leases. For operating leases, lessors continue to recognize the underlying asset. For finance leases, lessors derecognize the underlying asset and recognize a net investment in the lease similar to today's requirements. Any selling profit or loss is recognized at lease commencement.

Lessor accounting

Subsequent measurement

For operating leases, lessors recognize lease income on either a straight-line basis or another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

For finance leases, lessors recognize interest income for the accretion of the net investment in the lease and reduce that investment for payments received. The net investment in the lease is subject to the derecognition and impairment requirements in SLFRS 9 *Financial Instruments.*

Question 01

Sorento Export Ltd entered for a contract with Delta Leasing company. According to the contract a machinery will be provided for a 3 Year period subjected to following lease payments.
End of Year 01 - Rs 300,000
End of Year 02 – Rs 200,000
End of Year 03 – Rs 350,000
In addition to the above there is a requirement of residual payment of Rs 5,000 at the end the lease period. Implied rate of interest is 10%.

Answer

Year	01	02	03
Lease payments	300,000	200,000	350,000
Residual payment			5,000
	300,000	200,000	355,000
Discount Rate	0.909	0.826	0.751
	272,727	165,289	266,716

Present Value of the lease payment Rs 704,732

Right of use the Asset

Obligation to make the lease payment	704,732	Depreciation	234,911
		C/d	469,821
	704,732		704,732
B/f	469,821	Depreciation	234,911
		C/d	234,910
	469,821		469,821
B/f	234,910	Depreciation	234,910
	234,910		234,910

Obligation to make the lease payment

Cash	300,000	Right of use the Asset	704,732
C/d	475,206	P/L	70,474
	775,206		775,206
Cash	200,000	B/F	475,206
C/d	322,726	P/L	47,520
	522,726		522,726
		B/F	322,726
Cash	355,000	P/L	32,274
	355,000		355,000

Question 02

URL Manufacturing Ltd entered for a contract with WBL Leasing company. According to the contract a machinery will be provided for a 4 Year period subjected to following lease payments.

End of Year 01 - Rs 450,000
End of Year 02 – Rs 400,000
End of Year 03 – Rs 400,000
End of Year 04 - Rs 100,000

There is a agreed lease incentive payment during the year 3 and 4 based on the performance of the machine. If the output is more than 100,000 unit per annum without any major repairs it is required to make an additional payment of Rs 25,000 per annum.

In addition to the above there is a requirement of residual payment of Rs 150,000 at the end the lease period in order to obtain the ownership of the asset. Implied rate of interest is 12%.

Year	01	02	03	04
Lease payments	450,000	400,000	400,000	100,000
Incentive payment			25,000	25,000
Residual payment				150,000
	450,000	400,000	425,000	275,000
Discount Rate	0.893	0.797	0.712	0.636
	401,786	318,878	302,506	174,767

Present Value of the lease payment Rs 1,197,937

Right of use the Asset

Obligation to pay the lease payment	1,197,937	Depreciation	299484
		C/d	898,453
	1,197,937		1,197,937
B/f	898,453	Depreciation	299,484
		C/d	598,969
	898,453		898,453
B/f	598,969	Depreciation	299,484
		C/d	299,485
	598,969		598,969
B/f	299,485	Depreciation	299,485
	299,485		299,485

Obligation to pay the lease payment

Cash	450,000	Right of use the Asset	1,197,937
C/d	891,689	P/L	143,752
	1,341,689		1,341,689
Cash	400,000	B/F	891,689
C/d	598,691	P/L	107,002
	998,691		998,691
Cash	425,000	B/F	598,691
	245,535	P/L	71,844
	670,535		670,535
Cash	275,000	B/F	245,535
		P/L	29,465
	275,000		275,000

Question No 03

SLFRS 16 – *Leases* is applies to accounting periods beginning on or after 1 January 2019. However, earlier application is permitted. SLFRS 16 replaces LKAS 17 – *Leases*. SLFRS 16 makes substantial changes to the requirements for the recognition of rights and obligations under leasing arrangements for lessees.

Why it necessary to make significant changes to the requirements for the recognition of rights and obligations under leasing arrangements in the financial statements of lessees.

Answer

LKAS 17 – the previous financial reporting standard dealing with leasing – distinguished between two types of lease: finance and operating. LKAS 17 required lessees to recognize rights and obligations under leasing arrangements in the case of finance leases but not in the case of operating leases. The distinction between finance leases and operating leases in LKAS 17 was very subjective. Generally speaking, classifying leases as operating leases led to financial statements of lessees reporting a more favorable picture than classifying leases as finance leases. This incentive to treat leases as operating leases, together with the subjective nature of lease classification, meant that the requirements in LKAS 17 needed amending

Question No 04

How SLFRS 16 requires lessees to recognize and measure rights and obligations under leasing arrangements.

Answer

SLFRS 16 requires lessees to recognize a right of use asset and an associated liability at the inception of the lease. The initial measurement of the right of use asset and the lease liability will be the present value of the minimum lease payments.

The discount rate used to measure the present value of the minimum lease payments is the rate of interest implicit in the lease – essentially the rate of return earned by the lessor on the leased asset.

The right of use asset is subsequently depreciated in accordance with LKAS 16 – *Property, Plant and Equipment* (assuming it is a tangible asset).

The lease liability is effectively treated as a financial liability which is measured at amortized cost, using the rate of interest implicit in the lease as the effective interest rate.

Question No 05

ABC Ltd prepares financial statements to 31 Dec each year. On 1 Jan 2016, ABC Ltd began to lease a property on a 10-year lease. The annual lease payments were Rs 500,000, payable in arrears – the first payment being made on 30 Dec 2016. ABC Ltd incurred initial direct costs of Rs 60,000 in arranging this lease. The annual rate of interest implicit in the lease is 10%. When the annual discount rate is 10%, the present value of Rs 1 payable at the end of years 1–10 is Rs 6.145

Explain and show how these transactions would be reported in the financial statements of ABC Ltd for the year ended 31 December 2017 under SLFRS 16 – *Leases*.

The initial right of use asset and lease liability would be Rs 3,072,500 (500,000 x 6·145).

The initial direct costs of the lessee would be added to the right of use asset to give an initial carrying amount of Rs.3,132,500 (Rs3,072,500 + Rs 60,000).

Depreciation would be charged over a ten-year period, so the charge for the year ended 31 December 2017 would be Rs 313,250 (Rs. 3,132,500 x 1/10).

The closing carrying amount of PPE in non-current assets would be Rs 2,819,250 (Rs 3,132,500 x 9/10).

ABC Ltd would recognize a finance cost in profit or loss of Rs 307,250 (Rs 3,072,500 x 10%).

The closing lease liability would be Rs 2,879,750 (Rs 3,072,500 + Rs 307,250 – Rs 500,000).

Next year's finance cost will be Rs 287,975 (Rs 2,879,750 x 10%), so the current liability at 30 September 2017 will be Rs 212,025 (Rs 500,000 – Rs 287,975).

The balance of the liability of Rs 2,667,725 (Rs 2,879,750 – Rs 212,025) will be non-current.

Present Value of the lease payment – Rs 3,072,500 (500,000 x 6·145).

Right of use the Asset

Obligation to pay the lease payment	3,072,500	Depreciation	313,250
Direct Cost	60,000		
		C/d	2,819,250
	3,132,500		3,132,150
B/f	2,819,250		

Obligation to pay the lease payment

Cash	500,000	Right of use the Asset	3,072,500
C/d	2,879,750	P/L	307,250
	3,379,750		3,379,750
		B/F	2,879,750

Income Statement

Finance Expenses	
Lease interest	307,250
Depreciation	313,250

Statement of financial position

Asset	
Non- Current asset	
Right of Use the Asset	2,819,250
Liability	
Non- Current Liability	
Obligation to pay the lease payment (Rs 2,879,750 – Rs 212,025)	2,667,725
Current Liability	
Obligation to pay the lease payment (Rs 500,000 – Rs 287,975).	212,025