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LKAS 17 - Leases

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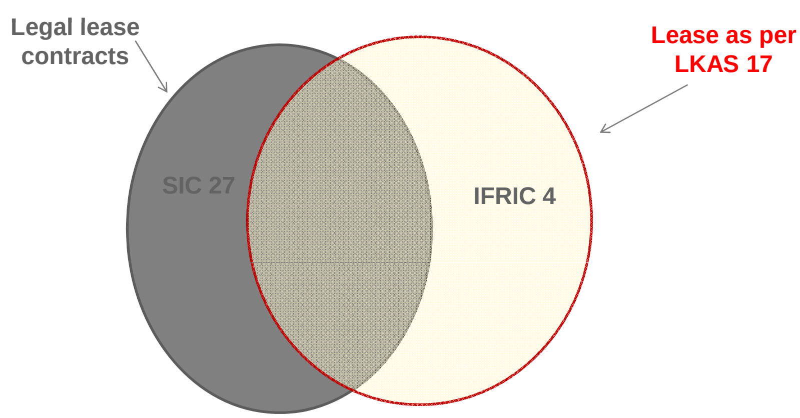
What is a lease?

'an agreement whereby the lessor conveys to the lessee *in* return for a payment or series of payments the right to use an asset for an agreed period of time.'

- The Lessor and the lessee
- Right to use an asset
- Payment or series of payments
- For an agreed period

IFRIC 4 vs. SIC 27



Scope of LKAS 17

- The standard applies in accounting for all leases other than:
  - lease agreements to **explore for or use minerals, oil, natural gas and similar non-regenerative resources**; and
  - **licensing agreements** for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Scope of LKAS 17 cont ...

- the standard should not be applied to **the measurement** by:
  - lessees of investment property held under finance leases (LKAS 40).
  - lessors of investment property leased out under operating leases (LKAS 40)
  - lessees of biological **assets** held **under** finance **leases** (LKAS **41)**
  - lessors of biological assets leased out under operating leases (LKAS 41)

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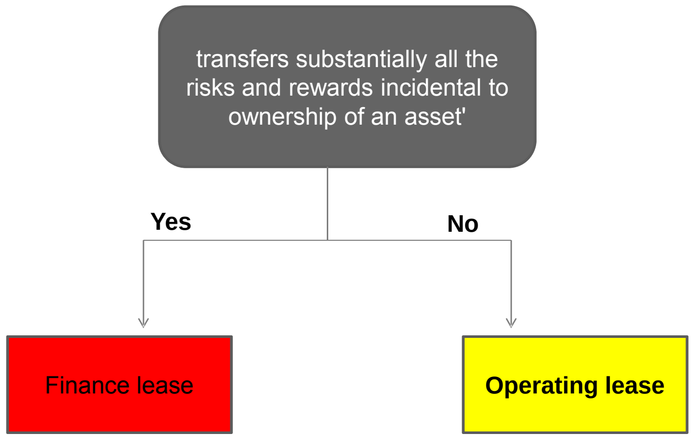
Lease classification



Situations which lead to a lease being classified as a finance lease :

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised (frequently called a 'bargain purchase' option);
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) 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
- (e) the leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Other indicators

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example, in the form of a rent rebate equaling most of the sale proceeds at the end of the lease); and
- (c) the lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

Inception of the lease

- The inception of the lease is the **earlier** of the **date of the lease agreement** and the **date of commitment of the parties to the principal terms of the lease**.
- This is the date on which
  - a lease is classified as a finance or operating lease and,
  - for finance leases, the date at which the amounts to be recognised at commencement are determined.

Commencement of the lease

- **The commencement** of the lease term is the **date on which the lessee is entitled to exercise its right to use the leased asset and is the date of initial recognition** of the assets, liabilities, income and expenses of the lease in the financial statements.
- This means that the entity makes an initial calculation of the assets and liabilities under a finance lease at inception of the lease but does not recognise these in the financial statements.

Fair value

- the amount for which an asset could be **exchanged** or a liability settled, between **knowledgeable**, **willing parties** in an **arm's length transaction**.
- In practice, the transaction price, i.e. the purchase price of the asset that is the subject of the lease, will be its fair value, unless there is evidence to the contrary.

Minimum lease payments

Lessee	Lessor
the payments over the lease term that the lessee is or can be required to make (Note 1) + any amounts guaranteed by the lessee or by a party related to the lessee; Note 1 : excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor Note 2: MLP includes the payment required to exercise the purchase option	the payments over the lease term that the lessee is or can be required to make (Note 1) + any residual guaranteed to the lessor by: (i) the lessee or by a party related to the lessee; or (ii) a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Residual value

- **The guaranteed residual value** is:

(a) **for a lessee,**

the part of the residual value that is guaranteed by itself or by one of its related parties. The amount of the guarantee is the maximum amount that could, in any event, become payable; and

(b) **for a lessor,**

it is the part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

- **The lessor's unguaranteed residual value** is any part of the residual value of the leased asset, the realisation of which is not assured or is guaranteed solely by a party related to it.

Lease term and non-cancellable period

- The lease term is the **non-cancellable period** for which the lessee has contracted to lease the asset, together **with any further terms for which the lessee has the option to continue to lease the asset**, with or without further payment, if it is reasonably certain at the inception of the lease that the lessee will exercise the option.

The lease term =

Non –cancellable period

+

further period(option to continue)

Non-cancellable period

- A non-cancellable lease is either;
  - a lease that has no cancellation terms
  - one that has terms that effectively force the lessee to continue to use the asset for the period of the agreement

Non-cancellable period Cont...

Therefore, a lease is considered to be non-cancellable if it can be cancelled only:

- on the occurrence of a remote contingency;
- with the permission of the lessor;
- if the lessee enters into a new lease with the same lessor for the same or an equivalent asset; or
- if the lessee is required to pay additional amounts that make it reasonably certain at inception that the lessee will continue the lease

Example : Lease term

- Lease agreement is for 5 years ,economic life of the asset is 6 years .
- Lease classification ?
- Lease agreement period ≠ lease term
- Hence , no conclusion can be made

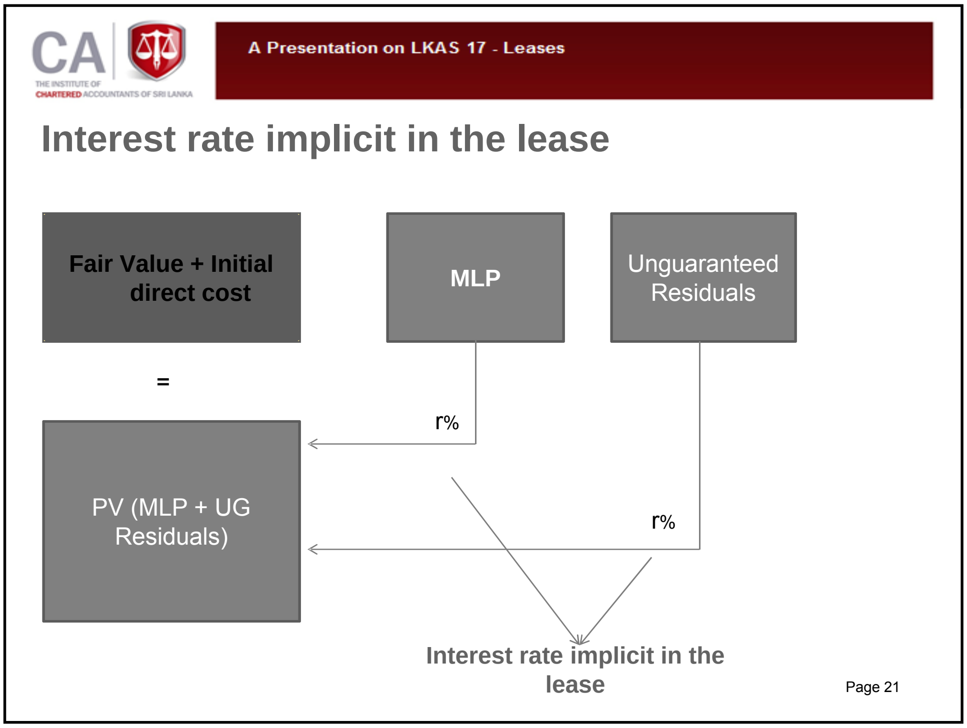
Example : Lease term

Condition	Lease term	Classification
No parties can cancel the lease	5 years	Finance lease
Only lessor can cancel the lease	5 years	Finance lease
Lessee may cancel after 2 years , but should pay penalty equivalent to remaining rentals	5 years	Finance lease
Lessee may cancel after 2 years , 3 months notice period	2 years	Operating lease
Lessee has an option to continue for further 3 years , (rent is substantially lower than the market rate for secondary period)	8 years	Finance lease

Interest rate implicit in the lease and incremental borrowing rate

- The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of
  - (a) the minimum lease payments; and
  - (b) the unguaranteed residual value

  to be equal to the sum of the fair value of the leased asset and any initial direct costs of the lessor.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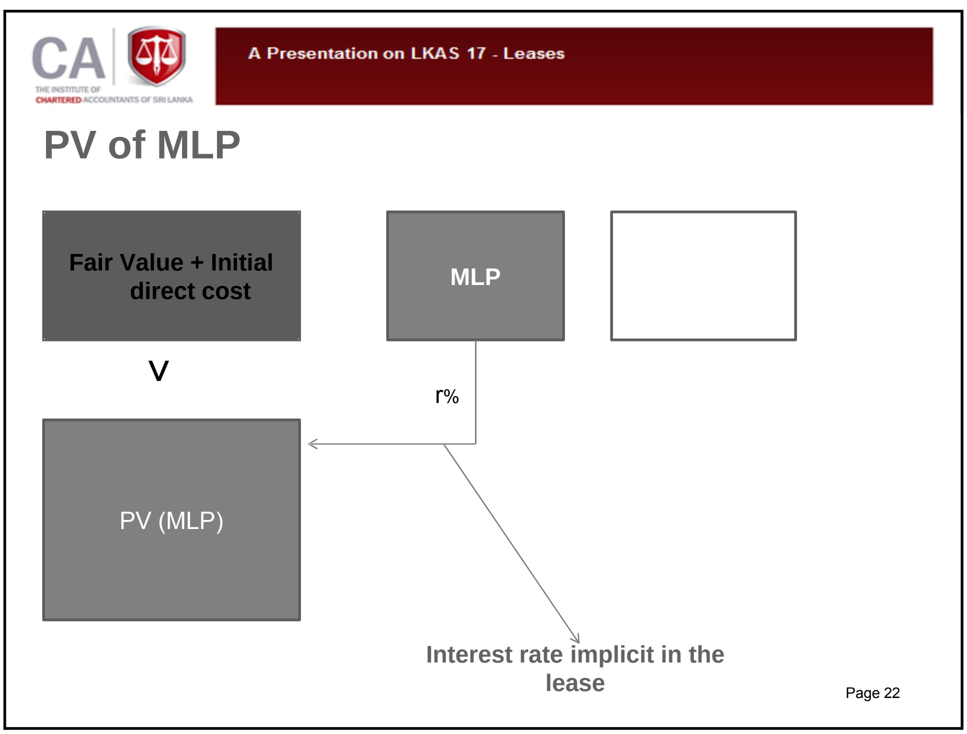
A Presentation on LKAS 17 - Leases
Interest rate implicit in the lease
Fair Value + Initial direct cost
MLP
Unguaranteed Residuals
=
r%
PV (MLP + UG Residuals)
r%
Interest rate implicit in the lease
Page 21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PV of MLP
Fair Value + Initial direct cost
MLP
V
r%
PV (MLP)
Interest rate implicit in the lease
Page 22

Incremental borrowing rate

- If it is not practicable to determine the implicit rate , then the lessee may use its incremental borrowing rate of interest.
- This is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Calculation of the implicit interest rate and present value of minimum lease payments

- Details of a non-cancellable lease are as follows:
  (i) Fair value = €10,000
  (ii) Five annual rentals payable in advance of €2,100
  (iii) Lessor's unguaranteed estimated residual value at end of five years = €1,000

The implicit interest rate : IRR formula

Year	FV	MLP	UGR	CF
0	(10,000)	2,100		(7,900)
1		2,100		2,100
2		2,100		2,100
3		2,100		2,100
4		2,100		2,100
5			1,500	1,000

19:F24)

Function Arguments

IRR

Values F19:F24 = {-7900;2100;2100;2100;2100;1000}

Guess = number

= 0.066219063

Returns the internal rate of return for a series of cash flows.

Values is an array or a reference to cells that contain numbers for which you want to calculate the internal rate of return.

Formula result = 6.62%

Help on this function

OK Cancel

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The implicit interest rate : RATE formula

Year	FV	MLP	UGR	CF
0	(10,000)	2,100		(7,900)
1		2,100		2,100
2		2,100		2,100
3		2,100		2,100
4		2,100		2,100
5			1,500	1,000

-1000,1)

Function Arguments

RATE

Nper 5 = 5

Pmt -2100 = -2100

Pv 10000 = 10000

Fv -1000 = -1000

Type 1 = 1

= 0.066219063

Returns the interest rate per period of a loan or an investment. For example, use 6%/4 for quarterly payments at 6% APR.

Type is a logical value: payment at the beginning of the period = 1; payment at the end of the period = 0 or omitted.

Formula result = 0.066219063

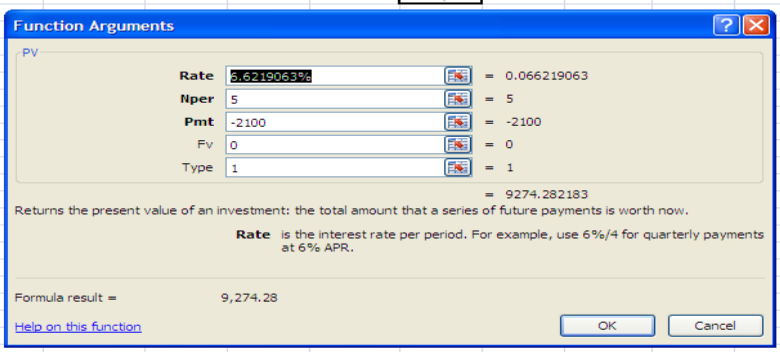
Help on this function

OK Cancel

Present value of minimum lease payments

Year	MLP	DF 6.621906%	PV
0	2,100	1.000	2,100
1	2,100	0.938	1,970
2	2,100	0.880	1,847
3	2,100	0.825	1,733
4	2,100	0.774	1,625
5	-	0.726	-
			9,274

100,0,1)



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Finance lease or operating lease

- 6.62% is the implicit interest rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payments (€10,500) and the unguaranteed residual value (€1,000) to be equal to the fair value of the leased asset.
- This implicit interest rate is then used to calculate the present value of the minimum lease payments, i.e. €10,500 discounted at 6.62%. This can be calculated at €9,274, which is 92.74% of the asset's fair value, indicating that the present value of the minimum lease payments is substantially all of the fair value of the leased asset and a finance lease is therefore indicated.

Contingent rent

- Contingent rents (which are excluded from minimum lease payments) are defined as that portion of the lease payments that are not fixed in amount, but are based on a factor other than just the passage of time
- for example,
  - percentage of sales,
  - amount of usage,
  - price indices,
  - market rates of interest)

Contingent rent cont...

- Contingent rents are embedded derivatives, as defined by LKAS 39, and in principle within scope of LKAS 39.
- An embedded derivative is a component of a hybrid or combined instrument that also includes a non-derivative host contract; it has the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative.
- In other words it causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified underlying.
- Embedded derivatives have to be separated from the host contract and recognised separately in the financial statements of the entity unless they are closely related to the economic characteristics and risks of the host contract.

Contingent rent cont...

- LKAS 39 specifically identifies the specific examples of contingent rents referred to above as being 'closely related' to the lease contract and hence not separately accounted for. [LKAS 39.11, AG33(f)]. This means that lessees continue to expense such contingent payments as they arise.
- However, other types of contingent rent could be embedded derivatives, e.g. an index that relates to inflation in another economic environment. [LKAS 39.AG33(f)].

Accounting

Party	Finance Lease	Operating lease
Lessee	X	X
Lessor : Finance	X	X
Lessor : Dealer /Manufacturing	X	X

Accounting for finance lease :the lessee

- At commencement of the lease, the asset and liability for the future lease payments are recorded in the balance sheet at the same amount, which is an **amount equal to the fair value of the leased asset or the present value of the minimum lease payments, if lower**, with initial direct costs of the lessee being added to the asset.
- lease payments should be **apportioned between the finance charge and the reduction of the outstanding liability**.
- The finance charge should be allocated to periods during the lease term so as **to produce a constant periodic rate of interest on the remaining balance** of the liability for each period.

Accounting for finance lease by the lessee

- The carrying amount of the liability will be calculated by adding the finance charge (however calculated) to the outstanding balance and deducting cash paid.
- Accounting for the leased asset **follows the general rules for accounting for property, plant and equipment or intangible assets.**
- The depreciation policy for depreciable leased assets should be **consistent with that for depreciable assets that are owned,** and the depreciation recognised should be calculated in accordance with LKAS 16 and LKAS 38.

Depreciation Period

If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term	Depreciable period
Yes	the period of expected use is the useful life of the asset.
No	the asset is be depreciated fully over the shorter of the lease term or its useful life

Example :Finance lease _Lessee

- Details of a non-cancellable lease are as follows:

(i) Fair value = €10,000

(ii) Five annual rentals payable in advance of €2,100

(iii) Lessor's unguaranteed estimated residual value at end of five years = €1,000

Note:

The lessor's direct costs have been excluded for simplicity.

Initial Recognition

Fair Value =10,000

PV of MLP =9,274

PPE	Dr		9,274	
Lease Liability		Cr		9,274

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Subsequent accounting : Lease liability Constant rate of return

Year	Liability at start of period	Rental paid	Liability during period	Finance charge (6.62% per annum)	Liability at end of period
	€	€	€	€	€
1	9,274	2,100	7,174	475	7,649
2	7,649	2,100	5,549	368	5,917
3	5,917	2,100	3,817	253	4,070
4	4,070	2,100	1,970	130	2,100
5	2,100	2,100	–	–	–
		10,500		1,226	

Current vs. non current liability

Year	Liability at end of period	Current liability at end of period	Non-current liability at end of period	Interest expense (at 6.62%) for the period
	€	€	€	€
0	9,274	1,625	7,649	0
1	7,649	1,732	5,917	475
2	5,917	1,847	4,070	368
3	4,070	1,970	2,100	253
4	2,100	2,100	–	130
5	–	–	–	–

Subsequent accounting : Lease liability _Sum of the digits method

- The total finance charges of €1,226 (total rentals paid of €10,500 less their present value of €9,274) are allocated over the lease term as follows:

Year	Number of rentals not yet due		$\frac{\text{total finance charge}}{\text{sum of number of rentals}}$	=	Finance charge per annum €
1	4	×	€1,226 ÷ 10	=	490
2	3	×	€1,226 ÷ 10	=	368
3	2	×	€1,226 ÷ 10	=	245
4	1	×	€1,226 ÷ 10	=	123
5	–	×	€1,226 ÷ 10	=	
	10				1,226

Comparison :Constant rate of return vs. Sum of the digit

	Annual finance charge		Annual finance charge as % of total rentals	
	IIR	Sum of the digits	IIR	Sum of the digits
Year	€	€	%	%
1	475	490	39	40
2	368	368	30	30
3	253	245	20	20
4	130	123	11	10
5	–	–	–	–
	1,226	1,226	100	100

Accounting for finance lease :the lessor

- Recognise assets held under a finance lease in their balance sheets as a receivable at an amount equal to the net investment in the lease.

  Net investment in the lease = gross investment in the lease discounted at the interest rate implicit in the lease.

  Net investments in the lease = gross investment in lease – unearned income

Accounting for finance lease :the lessor

- **Gross investment** in the lease is the aggregate of
  - the minimum lease payments (MLP) receivable by the lessor under a finance lease, and
  - any unguaranteed residual value accruing to the lessor.

Example : Finance Lease _ Lessor

Details of a non-cancellable lease are as follows:

(i) Fair value = €10,000

(ii) Five annual rentals payable in advance of €2,100

(iii) Lessor's unguaranteed estimated residual value at end of five years = €1,000

Note:

The lessor's direct costs have been excluded for simplicity

Interest rate implicit in the lease = 6.62%.

Gross investment vs. net investment

- The lessor's gross investment in the lease is the total rents receivable of €10,500 and the unguaranteed residual value of €1,000. (€11,500)
- The gross earnings/ unearned income =€1,500.
- The initial carrying value of the receivable is its fair value of €10,000, which is also the present value of the gross investment discounted at the interest rate implicit in the lease of 6.62%. (Net investment)

Allocation of finance income

Year	Receivable at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods	Receivable at end of period
	€	€	€	€	€	€
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	–	1,000
		10,500	1,500			

Manufacturer or dealer lessors

- Manufacturers or dealers often offer customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

  (a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

  (b) the finance income over the lease term.

Accounting for operating lease: The Lessee

- Lease payments under an operating lease shall be recognized as **an expense on a straight-line** basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

- **Prepayment or Accruals** shall be recognized to the extent the lease payment do not match expenses recognized in the income statements.

- Lease charges treated in same way as any other expense, under cash flows from **operating activities.**

Straight-line recognition over the lease term

- LKAS 17 does not incorporate adjustments to operating lease payments to reflect the time value of money.
- Except in those cases where another basis is more appropriate, it requires all operating leases to be taken on a straight-line basis.

Example: Operating lease expenses with fixed annual increment

- Entity A leases a property at an initial rent of €1,000,000 per annum.
- The lease has a non-cancellable term of 30 years and rent increases annually in line with the Retail Prices Index (RPI) of the country in which the property is situated but with a minimum increase of 2.5% (the estimated long-term rate of inflation in the country in question) and a maximum of 5% per annum.

Example: Operating lease expenses with fixed annual increment cont…

- The annual increase of 2.5% must be taken into account in calculating the operating lease payment charged to profit or loss.
- On a straight-line basis this will be €1,463,000 per annum. Therefore, by the end of year 15 (at which point the amounts payable under the lease will exceed the straight-lined amount) the entity will have paid rentals of €15 million, charged €22 million to income and will be recording an accrual of €7 million.
- If the increase in the RPI exceeds 2.5% these additional amounts will be charged to income as contingent rents.

Example: Notional or actual interest paid to lessors

- A lessee makes an interest-free security deposit of €1,000 on entering into a five year lease. It assesses an appropriate rate of interest for the deposit to be 4% and accordingly the fair value of the deposit at inception is €822. On making the deposit, it will record it as follows:

Year		€	€
1	Security deposit	822	
	Advance rentals	178	
	Cash		1,000

Example: Notional or actual interest paid to lessors

Year	Interest income	Rental expense	Difference
1	33	(36)	(3)
2	34	(35)	(1)
3	36	(36)	–
4	37	(36)	1
5	38	(35)	3
	178	(178)	

Accounting for operating lease: The Lessor

- Recognize the asset subject to operating leases as an asset according to its nature.
- Lease income from operating leases (excluding receipts for services provided such as insurance and maintenance) shall be recognized in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Accounting for operating lease: The Lessor

Cont…

- Costs, including depreciation, incurred in earning the lease income are recognised as an expense.
- Initial direct costs incurred by lessors 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 same basis as the lease income
- The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with LKAS 16 and LKAS 38.

SIC 15: Operating Leases—Incentives

- In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement.
  - An up-front cash payment to the lessee or
  - The reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee).
  - Initial periods of the lease term may be agreed to be rent-free or at a reduced rent.
- The issue is how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor.

Example :Relocation costs as incentive

An entity agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to pay the lessee's relocation costs as an incentive to the lessee for entering into the new lease. The lessee's moving costs are Rs.1,000. The new lease has a term of 10 years, at a fixed rate of Rs.2,000 per year.

The accounting is:

a. The lessee recognises relocation costs of Rs.1,000 as an expense in Year 1.

b. Net consideration of Rs.19,000 consists of Rs.2,000 for each of the 10 years in the lease term, less a Rs.1,000 incentive for relocation costs.

c. Both the lessor and lessee would recognise the net rental consideration of Rs. 19,000 over the 10 year lease term using a single amortisation method

Example :Relocation costs as incentive

	0	1	2	3	4	5	6	7	8	9	10
Lessee											
Income statement											
Relocation expenses		1,000									
Rent expense		1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900
		2,900	**1,900**	**1,900**	**1,900**	**1,900**	**1,900**	**1,900**	**1,900**	**1,900**	**1,900**
Liability	1,000	900	800	700	600	500	400	300	200	100	-
Lessor											
Rent income		1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900	1,900
Asset	1,000	900	800	700	600	500	400	300	200	100	-

-

Example: rent –free period

- An entity agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to a rent-free period for the first three years as incentive to the lessee for entering into the new lease. The new lease has a term of 20 years, at a fixed rate of 5,000 per year for years 4 through 20.

- The accounting is:
- Net consideration of 85,000 consists of 5,000 for each of 17 years in the lease term.
- Both the lessor and lessee would recognise the net consideration of 85,000 over the 20 year lease term using a single amortisation method.

Example : rent –free period

	0	1	2	3	4	5	6	18	19	20
.										
Rent expense		4,250	4,250	4,250	4,250	4,250	4,250	4,250	4,250	4,250
Liability		4,250	8,500	12,750	12,000	11,250	10,500	1,500	750	-
Lessor										
Rent income		4,250	4,250	4,250	4,250	4,250	4,250	4,250	4,250	4,250
Asset		4,250	8,500	12,750	12,000	11,250	10,500	1,500	750	-

Sale and leaseback

- 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 the seller/lessee (the original owner) and buyer/lessor (the finance provider) respectively.
- The sale and leaseback transactions can result in either a finance lease or an operating lease as determined by applying the principle of substance over form. As the accounting treatment depends on this categorization, this decision is critical.

Sale and finance leaseback

- Derecognise the carrying amount of the asset now sold
- Recognise the sales proceeds
- Calculate the profit on sale and recognize it as deferred income
- Recognise the finance lease asset and the associated liability and measure them in the normal way. (lower of fair value and the present value of minimum lease payment)
- Recognise the profit on sale as income over the lease term.

Example : Sale and finance lease back

- An asset that has a carrying value of €700 and a remaining useful life of 7 years is sold for €1,200 and leased back on a finance lease.
- This is accounted for as a disposal of the original asset and the acquisition of an asset under a finance lease for €1,200. The excess of sales proceeds of €500 over the original carrying value should be deferred and amortised (i.e. credited to profit or loss) over the lease term.
- The net impact on income of the charge for depreciation based on the carrying value of the asset held under the finance lease of €171 and the amortisation of the deferred income of €71 is the same as the annual depreciation of €100 based on the original carrying amount.

Sale and operating leaseback

- The objective of this type of transactions is to obtain the finance for the replacement of asset whilst occupying it for the period of construction.
- For example, a cricket club might sell its stadium, and then lease it back for a year, whist using the proceeds to fund the construction of a new stadium.

Recognize the profit or loss

- How to recognizes the profit and loss of the sale transaction is depend on the relationship between the sale price and fair value .
- **If the sale price is established at fair value** , any profits of loss should be recognized immediately
- **If the sale price is below fair value**, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.
- **If the sale price is above fair value**, the excess over fair value shall be deferred and amortized over the period for which the asset is expected to be used.
- **if the fair value** at the time of a sale and leaseback transaction is **less than the carrying amount** of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognized immediately.

Sales price (SP) = Fair Value (FV)

	CA = FV	CA <FV	CA>FV
Profits	No profit	Recognise Profits immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately

Sales price (SP) < Fair Value (FV)

	CA = FV	CA <FV	CA>FV
Profits	No profit	Recognise profit immediately	No profit (Note 1)
Loss not compensated immediately for by future lease rentals below market rate	Recognise loss immediately	Recognise loss immediately	(Note 1)
Loss compensated for by future lease rentals below market rate	Defer and amortise loss	Defer and amortise loss	(Note 1)

Note 1 :
Paragraph 63 of LKAS 17 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Sales price (SP) > Fair Value (FV)

	CA = FV	CA <FV	CA>FV
Profits	Defer and amortise profits	Defer and amortise (SP – FV) Recognise immediately (FV – CA)	Defer and amortise profit (Note 2)
Loss	No loss	No loss	(Note 1)

Note 2 :
Profit is the difference between fair value and sale price because the carrying amount would have been written down to fair value in accordance with paragraph 63 of LKAS 17.

Sub-leases and back-to-back leases

No:	Lessor	Intermediate party		Lessee
	Lease to Intermediate	*Lease from Lessor*	*Lease to Lessee*	*Lease from Intermediate*
(1)	Operating lease	Operating lease	Operating lease	Operating lease
(2)	Finance lease	Finance lease	Operating lease	Operating lease
(3)	Finance lease	Finance lease	Finance lease	Finance lease

Sub-leases and back-to-back leases Cont...

(1) an operating lease from the lessor to the intermediate and from the intermediate to the lessee.

- The intermediate may be liable to the lessor if the lessee defaults, in which case it would have to make an appropriate provision, but otherwise both contracts are executory and will be accounted for in the usual way.

(2) the intermediate will record at inception an asset acquired under a finance lease and an obligation to the lessor of an equal and opposite amount. It is appropriate for the intermediate party to record a fixed asset, which it will have to depreciate.

Sub-leases and back-to-back leases Cont...

(3), the intermediate is the lessee under a finance lease with the lessor and lessor under a finance lease with the lessee.

Its balance sheet, prima facie, records a finance lease receivable from the lessee and a finance lease obligation to the lessor.

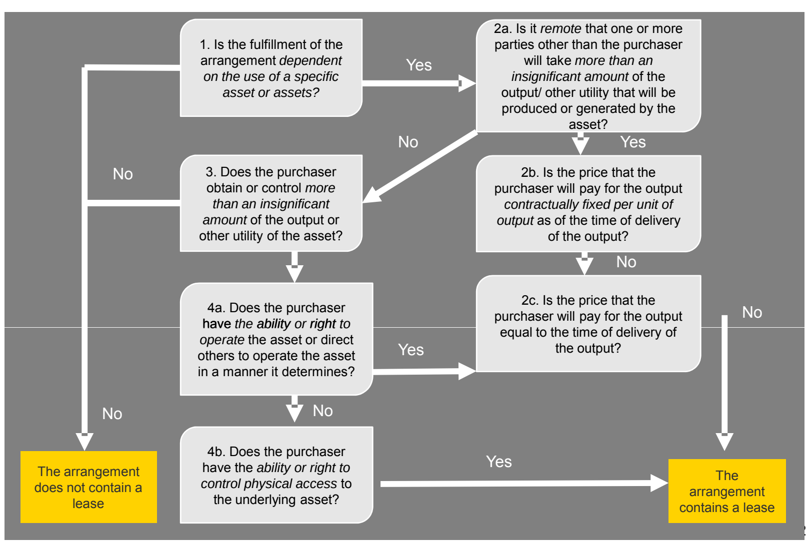
IFRIC 4: Determining whether an Arrangement contains a Lease

- In recent years arrangements have developed that do not take the legal form of a lease but which convey rights to use assets in return for a payment or series of payments. Examples of such arrangements include:
  - outsourcing arrangements;
  - telecommunication contracts that provide rights to capacity; and
  - take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services.

- This Interpretation provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with LKAS 17. It does not provide guidance for determining how such a lease should be classified under that Standard.

A Presentation on LKAS 17 - Leases

Leases – IFRIC 4



Specific vs. alternative asset (case A)

- An arrangement in which an entity outsources its product delivery department will not depend on a specific asset if the supplier is obliged to make available a certain number of delivery vehicles of a certain standard specification and the supplier is a delivery organisation with many other vehicles available.
- However, if for example the supplier has to use and maintain a specified number of specialist vehicles in the purchaser's, then this arrangement depends on a specific asset.

Specific vs. alternative asset (case B)

- An arrangement in which an entity outsources its storage of confidential data may depend on a specific asset if the agreement stipulates that the hardware (computer and terminals) must meet specific criteria to interface with the entity’s own system such that they can be used in providing services only to that entity.

Specific vs. alternative asset (case C)

- In the case of a power purchase contract, if the seller of the power is a special purpose entity (SPE) that owns a single power plant, that power plant is implicitly specified in the contract if it is unlikely that the SPE could obtain replacement power to fulfil its obligations under the contract.

Specific vs. alternative asset (case D)

- A purchaser enters into a take-or-pay contract to buy industrial gases from a supplier. The supplier is a large company operating similar plants at various locations. Both parties anticipate that the gases will be supplied from a particular plant.
- However, because a good distribution network is available, the supplier is able to provide gas from various locations to fulfil its supply obligation. The arrangement does not depend on a specific asset because it is economically feasible and practical for the supplier to fulfil the arrangement by making use of more than one plant.

Arrangements containing a lease Power plant

- **Typical terms and conditions**
- The power plant is explicitly identified in the arrangement, and the supplier has to supply electricity from this specifically identified plant.
- The supplier has no right to provide electricity to other parties. (It is not possible to provide to other parties)
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of electricity each month.
- Each month, the CEB will pay a fixed capacity charge and a variable charge based on electricity supplied.
- CEB must pay the fixed capacity charge irrespective of whether it takes any of the facility's production.
- The variable charge includes the power plant's actual energy costs, which amount to about XX per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Arrangements containing a lease Power plant Cont....

- **Assessment**
- The arrangement contains a lease within the scope of LKAS 17
- An asset (the power plant) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the power plant.
- CEB obtained the right to use the power plant because,
  - power plant is designed to meet only the CEB's needs
  - it is remote that one or more parties other than the CEB will take more than an insignificant amount of the facility's output
  - the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Note :

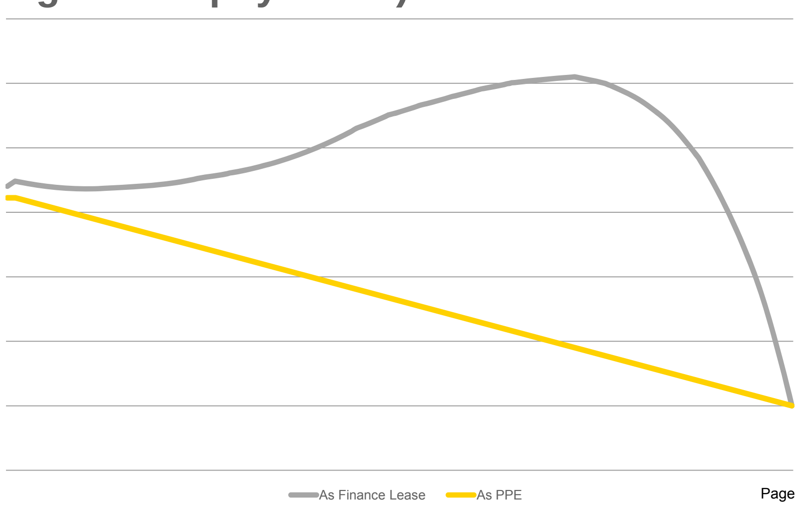
It is assumed that the said power plant is not within the scope of IFRIC 12 : Service concession arrangement

Arrangements containing a lease Accounting by the seller

	Traditional method	As a lease under IFRIC 4	
		Finance Lease	**Operating Lease**
Initial investment	PPE	Lease receivable	PPE
variable revenue	Revenue	Revenue	Revenue
Capacity charge / Fixed component	Revenue (as per the agreement)	Lease repayment	Rent income (straight line method)
Depreciation	Yes	No	Yes
Interest income	No	Accrue on lease receivable by using Effective Interest rate	No
Impairment as per	LKAS 36	LKAS 39	LKAS 36

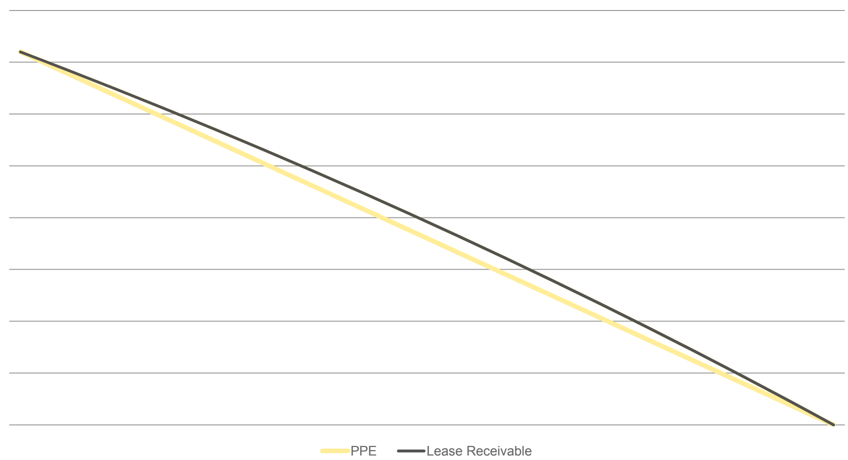
A Presentation on LKAS 17 - Leases

IFRIC 4 : The difference it can make (progressive payments)



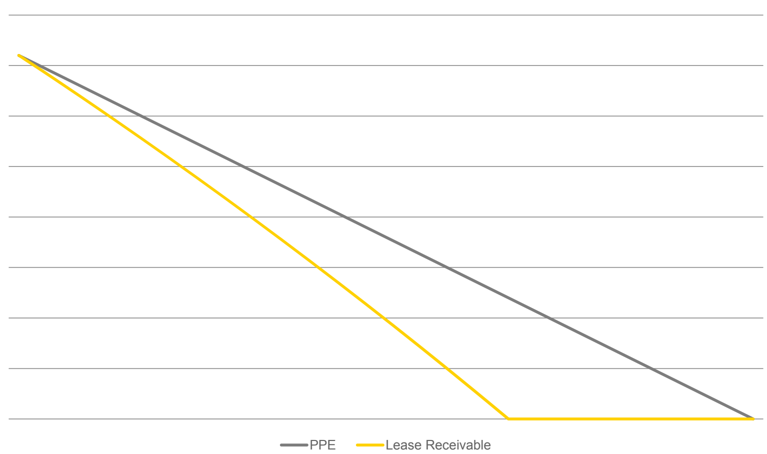
A Presentation on LKAS 17 - Leases

IFRIC 4 : The difference it can make (equated payments)



A Presentation on LKAS 17 - Leases

IFRIC 4 : The difference it can make (equated payments pattern and higher useful life)



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Investment property

- Entities are permitted to treat interests held under operating leases as investment properties – providing that they would otherwise meet the standard's investment property definition and the fair value model is applied.

Investment property Cont...

- This classification alternative is available on a property-by-property basis so that the entity need not classify all property interests held under operating leases as investment property.
- However, LKAS 40 requires that once one operating leasehold interest is classified as an investment property, all property classified as investment property must be accounted for under the fair value method.

Land & Building

LKAS 17 (2012)

14 [Deleted]

15 [Deleted]

15A **When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13.** In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

14 Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets. However, a

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LKAS 17

characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.

15 The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification. If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analysed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements. When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term, in accordance with paragraph 14. The buildings element is classified as a finance or operating lease in accordance with paragraphs 7–13.

Land & Building Cont...

- The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification.
- If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analyzed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements.

Land & Building Cont...

- Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.
- If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

Leases of land and buildings

- **Case A:**
  - Company A leases a building (and the underlying land) for 10 years. The remaining economic life of the building when the lease is entered into is 30 years. The lease is for considerably less than the economic life of the building so it is clear that both the land and buildings elements are operating leases and no separation is necessary.

Leases of land and buildings

- **Case B:**
  - Company B takes on a 30-year lease of a new building and the underlying land. It is on a retail park and almost all of the value is ascribed to the building as land values are low. Although the building has a fabric life of 60 years, its economic life is estimated to be 30 years, after which it is expected to be technologically obsolete.
  - The lease is for most of the economic life of the buildings and the present value of the minimum lease payments amounts to substantially all of the fair value of the building. It is not legally possible to lease the building without leasing the underlying land or, therefore, to estimate the relative fair values reliably. In any event, the lessor retains the residual value in the land and the lessee's interest in the land alone must be insignificant.
  - The entire lease is accounted for as a finance lease with an economic life of 30 years.

Leases of land and buildings

- **Case C:**
  - Company C takes out a 25 year non-cancellable lease of premises in the centre of a major town where land values are high. There are upward-only rent reviews every 5 years. It is a modern building that may have a remaining economic life of 35 years (or perhaps more, as the building has a fabric life of 60 years) and the land is clearly valuable to the lessor, who will want a reasonable return from it over the lease term.
  - In this case the interest in the building may or may not be a finance lease and the lessee's leasehold interest in the land is not insignificant. Company C will have to undertake a valuation exercise to determine the allocation of minimum lease payments between the land and building elements of the lease in order to determine whether or not it has finance or operating leases over the land and buildings.

Financial Instruments Standard (LKAS 39)

- LKAS 39 scoped out rights and obligations under leases to which LKASS 17 *Leases* applies.
- However:

  (i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of LKAS 39

  (ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of LKAS 39; and

  (iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of LKAS 39

Thank you.

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