



## **Leases (LKAS 17)**

**18<sup>th</sup> October 2016**

**Uditha De Zoysa**



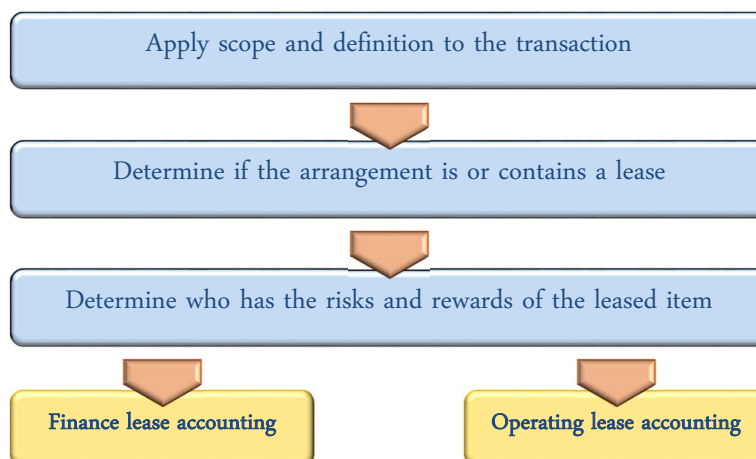
## Agenda

- **The basic framework**
- Scope and definition
- Arrangements containing a lease
- Lease classification
- Operating lease accounting
- Finance lease accounting
- Real estate leases
- Sale and leaseback
- Disclosure

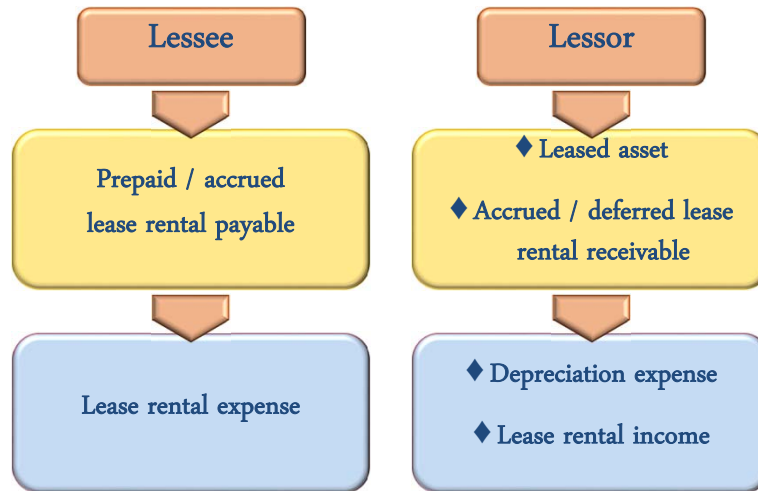
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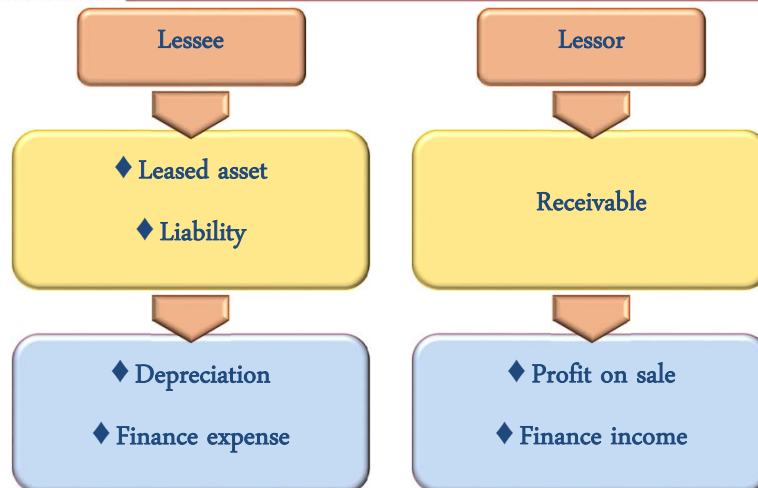
## The basic framework



## Operating lease accounting



## Finance lease accounting





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## Definition of a lease

Transfers right to use  
an asset



Agreement that transfers right  
to use an asset for agreed  
amount of time



Payment



In return for payment



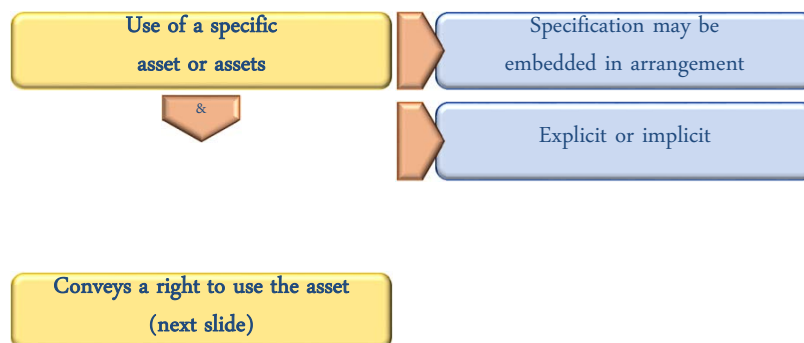
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## Arrangements containing a lease (factors) (1)



## Arrangements containing a lease (factors) (2)

Use of a specific asset or assets (previous slide)

&

Conveys a right to use the asset

Ability / right to operate / direct another to operate while obtaining > insignificant amount of output

Ability / right to control physical access while obtaining > insignificant amount of output

Remote that one or more parties will take > insignificant amount of the output and output is not contractually fixed per unit or equal to current market price

## A question for you: Arrangement contains a lease

- **Clean Products enters into an agreement with a supplier for packing cleaning bottles at the supplier's bottling plant into crates for 3 years:**
  - **The bottling plant is explicitly identified**
  - **The bottling plant is only used to pack bottles for Clean Products, and Clean Products controls physical access**
  - **Each month Clean Products pays a fixed price of L\$ 10,000**
  - **Clean Products has the option to change supplier without losing control over the bottling plant**

**Has Clean Products entered into a lease of the bottling plant?**





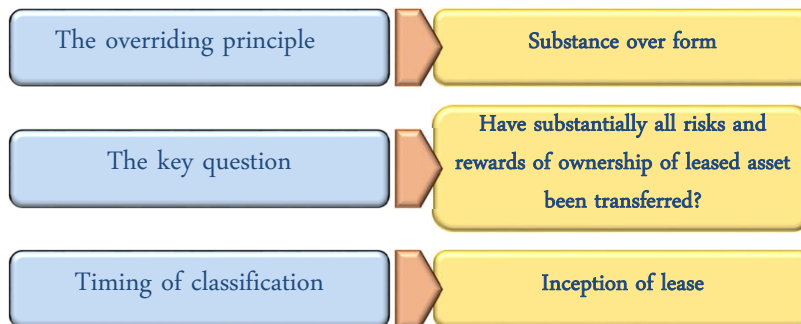
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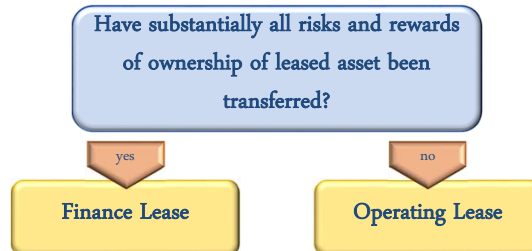
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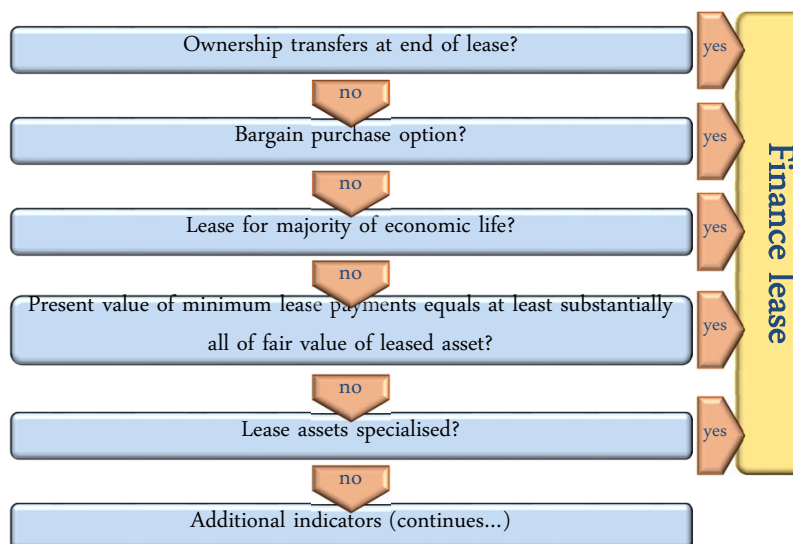
## Classification



## The key question



## Indicators of a finance lease





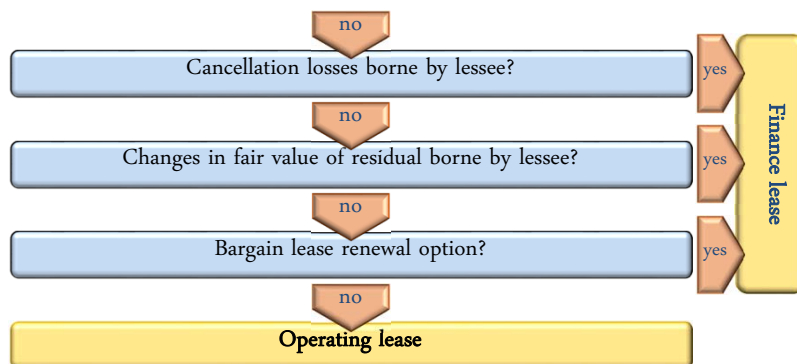
A question for you: Classification (1)

- Beauty Cosmetics rents a Fat-Burner equipment from a third party (lessor) for 4 years
- Monthly payments are L\$ 40,000
- At the end of 4 years, the Fat-Burner will be returned to the lessor unless Beauty Cosmetics pays the lessor L\$ 20,000, in which case ownership will transfer to Beauty Cosmetics
- The Fat-Burner's expected useful life is 8 years

**Do you think that Beauty-Cosmetics has entered into an operating lease or a finance lease?**



More indicators of a finance lease





## A question for you: Classification (2)

- Beauty Cosmetics rents a photocopying machine from a third party (lessor) for 3.5 years
- At the end of the lease period, the photocopier will be returned to the lessor
- The expected useful life of the photocopier is 4 years

**Do you think that Beauty Cosmetics has entered into an operating lease or a finance lease?**



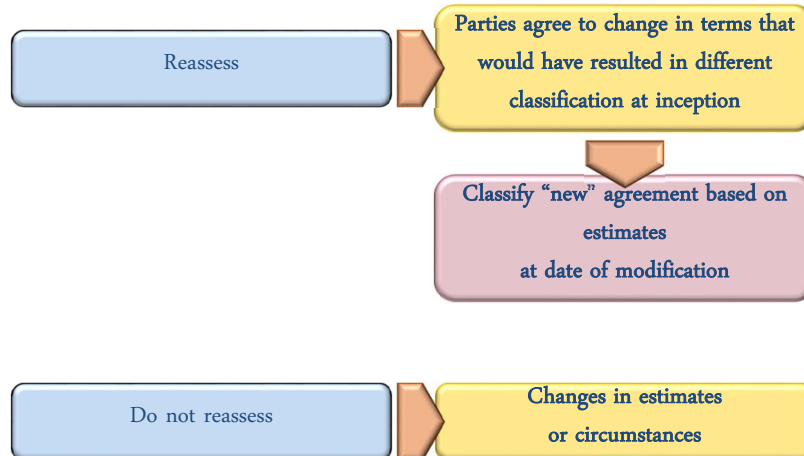
## A question for you: Classification (3)

- Beauty Cosmetics rents 2 new cars from a third party (lessor) for 2 years, after which time the cars will be returned to the lessor
- Total rental payments amount to about 70% of the new price of the cars

**Do you think that Beauty Cosmetics has entered into an operating lease or a finance lease?**



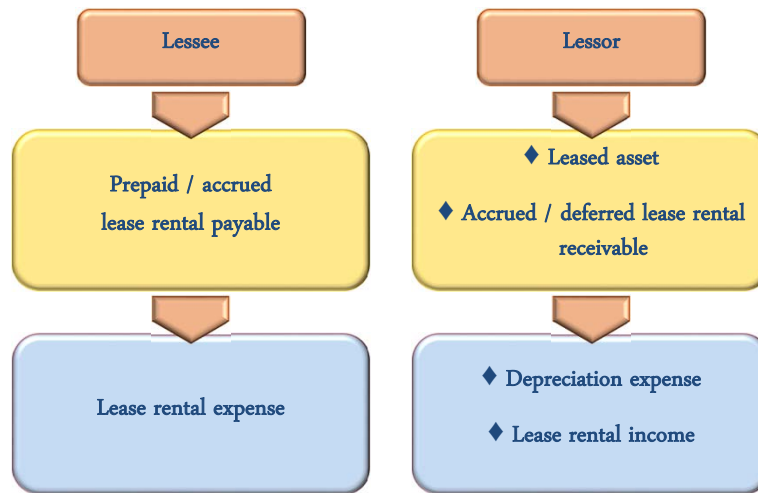
## Timing of classification: Reassessment



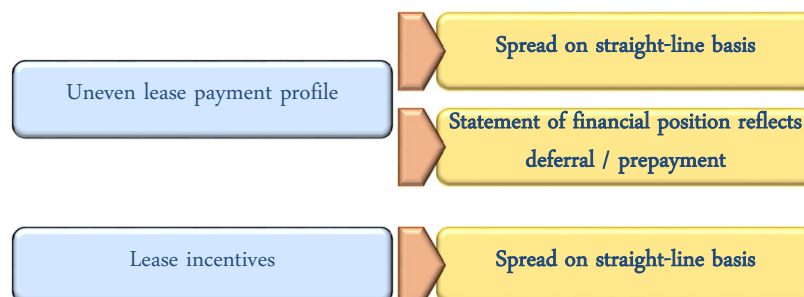
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## Accounting for operating leases



## Other considerations: Operating leases





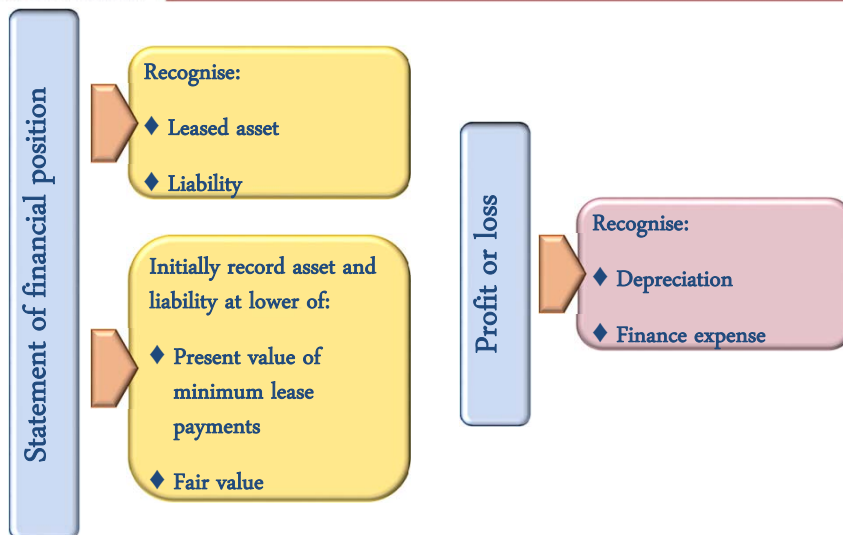
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## Finance lease accounting: Lessee



## Minimum lease payments

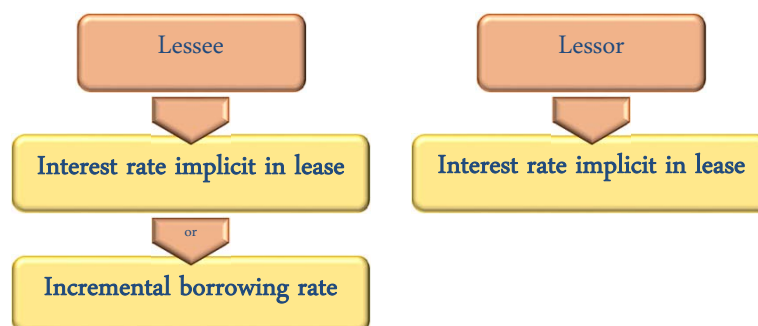
### Include

- Non-cancellable lease payments
- Guaranteed residual value
- Purchase option if reasonably certain of exercise
- Lease payments under bargain renewal option

### Exclude

- Contingent rent
- Cost for services
- Taxes if paid by and reimbursed to the lessor

## Discount rate for present value





## Guaranteed residual value

Lessee

- ◆ Lessee guarantees value of asset at end of lease term
- ◆ Lessee at risk for residual value
- ◆ Include residual value guaranteed in minimum lease payments

Lessor

- Any party (including lessee) guarantees value of asset at end of lease term
- ◆ Lessor not at risk for residual value
- ◆ Include residual value guarantee in minimum lease payments



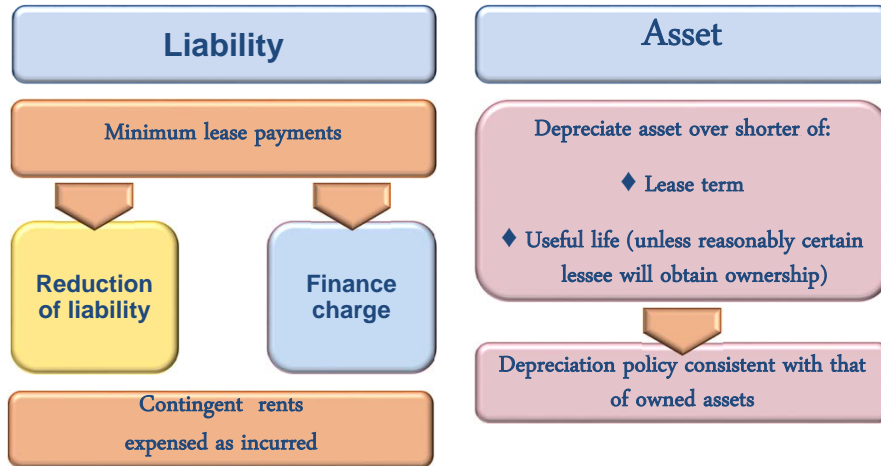
## A question for you: Minimum lease payments

- Beauty Cosmetics rents retail premises in a shopping mall from a third party (lessor) for 10 years
- The base rental is L\$ 50,000 per annum, of which L\$ 5,000 is for maintenance services provided by the lessor
- Beauty-Cosmetics also pays contingent rental of 10% of revenues, which is expected to be L\$ 25,000 per annum at inception
- The lessor expects the fair value of the retail premises to be L\$ 100,000 at the end of the lease, which Beauty Cosmetics agrees to pay at the end of the lease

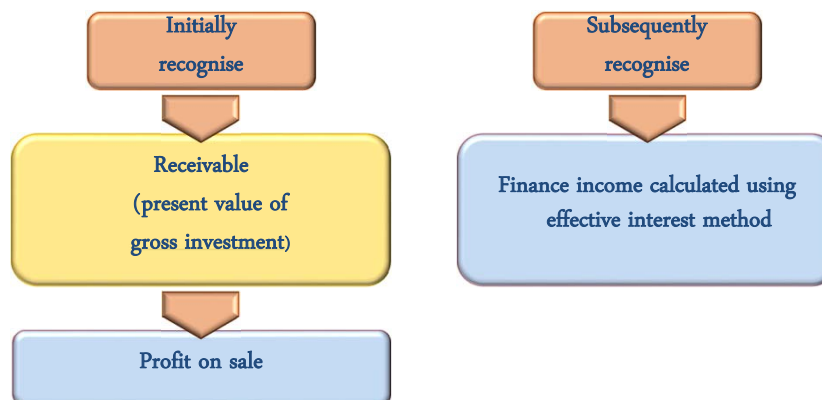
**Determine the minimum lease payments for Beauty-Cosmetics**



## Finance lease subsequent accounting: Lessee

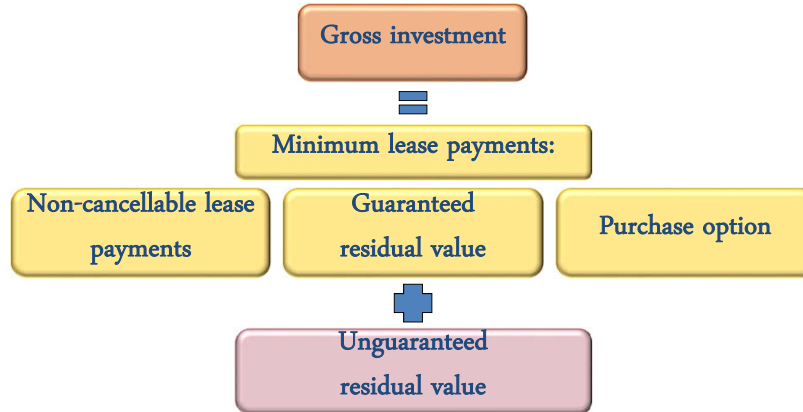


## Finance lease accounting: Lessor

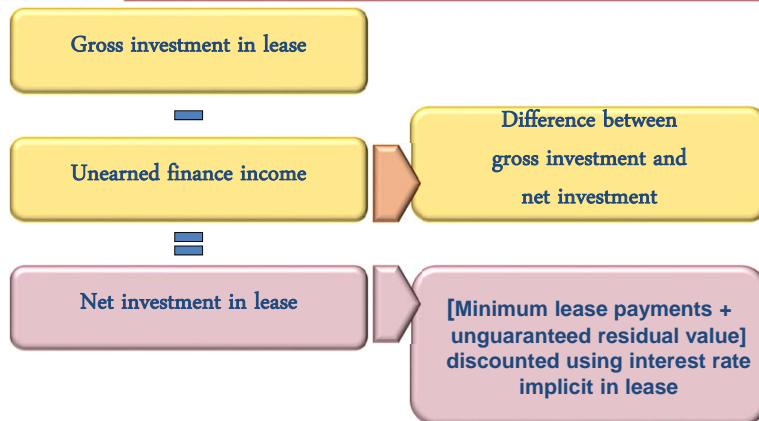




## Lessor: Gross investment



## Lessor: Lease receivable



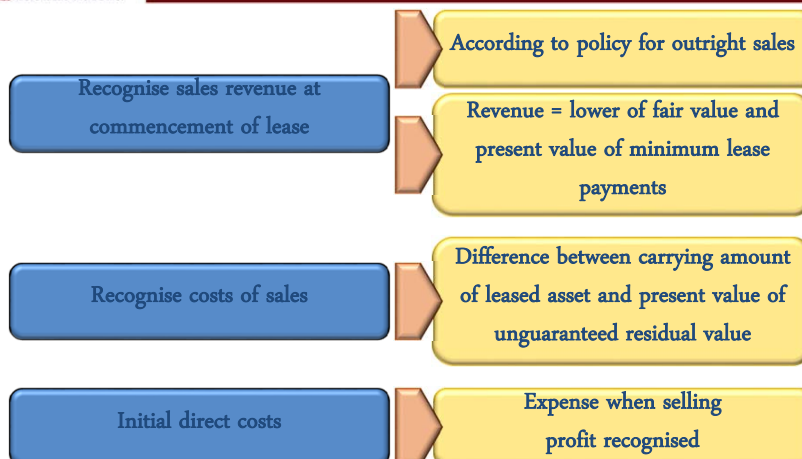
## A question for you: Lessor lease receivable

- Beauty Cosmetics rents retail premises in a shopping mall from a third party (lessor) for 10 years
- Base rental is L\$ 50,000 per annum, of which L\$ 5,000 is for maintenance services provided by the lessor
- Beauty Cosmetics also pays contingent rental of 10% of revenues, which is expected to be L\$ 25,000 per annum at inception
- The lessor expects the fair value of the retail premises to be L\$ 200,000 at the end of the leases. Beauty Cosmetics agrees to pay the lessor L\$ 100,000 at the end of the lease
- The rate implicit in the lease is 10%

**Determine the lessor's gross investment in the lease and lease receivable**



## Manufacturers / dealers as lessors





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## Classification of real estate leases

Lease of both land and building: requires classification of each element

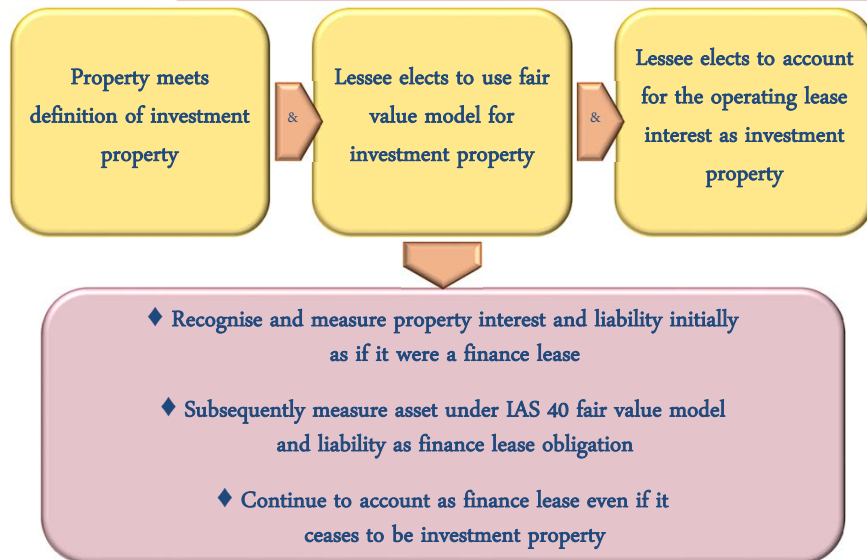
Land lease may be classified as a finance lease if substantially all risks and rewards transferred to lessee

Minimum lease payments allocated to land and buildings based on relative fair values of leasehold interests



If reliable allocation not possible, treat both as finance lease unless clear that both elements are operating leases

## Real estate leases as investment property



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## Sale and leaseback transactions



Super-Tech sells building to Buildings Inc

Buildings Inc leases the building  
back to Lila-Tech

Is it an operating leaseback  
or a finance leaseback?

## Operating leaseback profit or loss recognition

Sale price = FV

Recognise in profit or  
loss immediately

Sale price > FV

Defer and amortise  
excess over FV  
over asset's useful life

Sale price < FV

*and, in case of a loss, not compensated  
by future below-market lease payments*

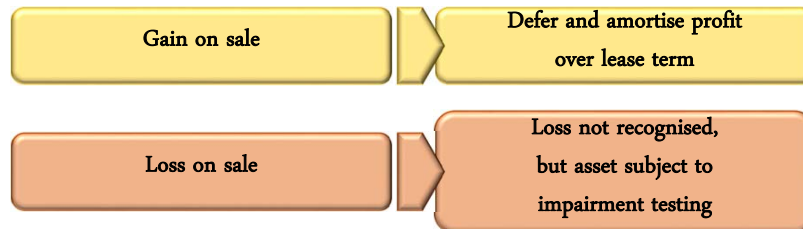
Recognise in profit or  
loss immediately

Sale price < FV

*and, in case of a loss, is compensated by  
future below-market lease payments*

Defer and amortise loss  
over asset's useful life

## Finance leaseback profit or loss recognition



### A question for you: Sale and leaseback (1)

- Lila-Industrial sells a machine (carrying amount L\$ 11 million) to Lila-Pharma for its fair value of L\$ 20 million. Lila-Industrial leases it back for 10 years at lease payments of L\$ 2.7 million per year
- At the transaction date, the expected value of the machine at the end of the lease term is L\$ 12 million
- At the end of the 10 years, Lila-Industrial can repurchase the machine for L\$ 3 million
- Lila-Industrial derecognised the asset and recorded a profit on sale of L\$ 9 million
- At inception, the present value of minimum rental payments is L\$ 18.5 million and the present value of repurchase option is L\$ 1.5 million

**What adjustments should Lila-Industrial prepare?**





## Questions



## Contact details

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