Financial Accounting & Reporting

[AA31]

Supplementary for
Chapter 03 - Part II
(From Sub Topic 3.2.2 to 3.2.2.7)

Accounting Standards

-Leases-

Testing from January 2020 Examination

3. Accounting Standards - Part II

3.2.2 Leases (SLFRS 16)

3.2.1 Definitions

Lease

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.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Period of Use

The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

Inception date of the lease

The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

Commencement date of the lease

The date on which a **lessor** makes an **underlying** asset available for use by a **lessee**.

Underlying asset

An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

Lease Term

The non-cancellable period for which a lessee has the right to use an **underline asset**, 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

The lease term begins at the commencement date and includes any rent- free periods provided to the lessee by the lessor.

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.

For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.

Lease Incentives

Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

Discount Rates

Interest rate implicit in the lease

The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) **any initial direct costs** of the lessor.

Lessee's incremental borrowing rate

The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use** asset in a similar economic environment.

Initial Direct Costs

Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.

Economic Life

Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

Fair Value

For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Finance Lease

A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Gross Investment in the lease

The sum of:

(a) the **lease payments** receivable by a **lessor** under a **finance lease**; and

(b) any **unguaranteed residual value** accruing to the lessor.

Lease Modification

A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

Net Investment in the lease

The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.

Residual Value Guarantee

A guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.

Right of Use Asset

An asset that represents a **lessee's right** to use an **underlying asset** for the **lease term**.

Sublease

A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect.

Unearned Finance Income

The difference between:

(a) the **gross investment in the lease**; and

(b) the **net investment in the lease**.

Unguaranteed Residual Value

That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.

Variable Lease Payments

The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

3.2.2 Determining whether an arrangement contains a lease

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract **conveys the right to control the use** of an **identified**

asset for a period of time in exchange for consideration.

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset; and

(b) the right to direct the use of the identified asset.

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Eg: Example 01

Explicitly Specified Asset

Customer A enters into a five years contract with Supplier B for the use of floor of a building on rent. The floor number and the number of square feet are given in the contract clearly. Is there an identified asset?

A Analysis

Yes, It is. Asset is explicitly specified in the contract and accordingly there is an identified asset.

Eg: Example 02

Implicitly Specified Asset

Customer X enters into a five year contract with supplier Y for the provision of transport materials in the production floor. Supplier Y is using his one and only forklift for the provision of this service. There is no assets specifications are given in the contract between these two parties. Is there an identified asset?

A Analysis

Yes, Forklift is an identified asset. While the forklift is not explicitly specified in the contract, it is implicitly specified because supplier Y must use it to fulfil the contract.

Example 03

Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a lorry for a three year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified lorry is not operational (e.g. if it breaks down)

Under the contract:

- Customer X operates the vehicle (i.e. drives the vehicle on his own) or directs others to operate the vehicle (e.g. operate through a driver)
- Subjected to the contractual limitations, Customer X decides how to use the vehicle. For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when it is used and what purpose it is used for. Customer X can also change these decisions throughout the period of use.
- To protect the supplier's interest over the asset, Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and making modifications to the vehicle.

Analysis

Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer has the right to decide the purpose of the vehicle is used for, when or whether the vehicle is used, where the vehicle goes.

Limitations imposed by the Supplier Y on certain uses of the vehicle and making modifications to it, are considered as protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

Substantive substitution rights

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

(a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and

(b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

Eg: Example 04

Substantive substitution right

Customer A enters into a contract with supplier B for use of a car for a period of 5 years. Assets specifications such as vehicle number, model, colour etc. are clearly specified in the agreement. Supplier B is in the business of renting out similar type of vehicles and is permitted to substitute a rented out vehicle from another vehicle available with him. Does the customer have the right to use this identified asset through-out the period?

A Analysis

The customer does not have the right to use an identified asset because, the supplier B has the practical ability to substitute the asset at any given point during the lease term. Therefore this contract does not contain a lease.

Eg: Example 05

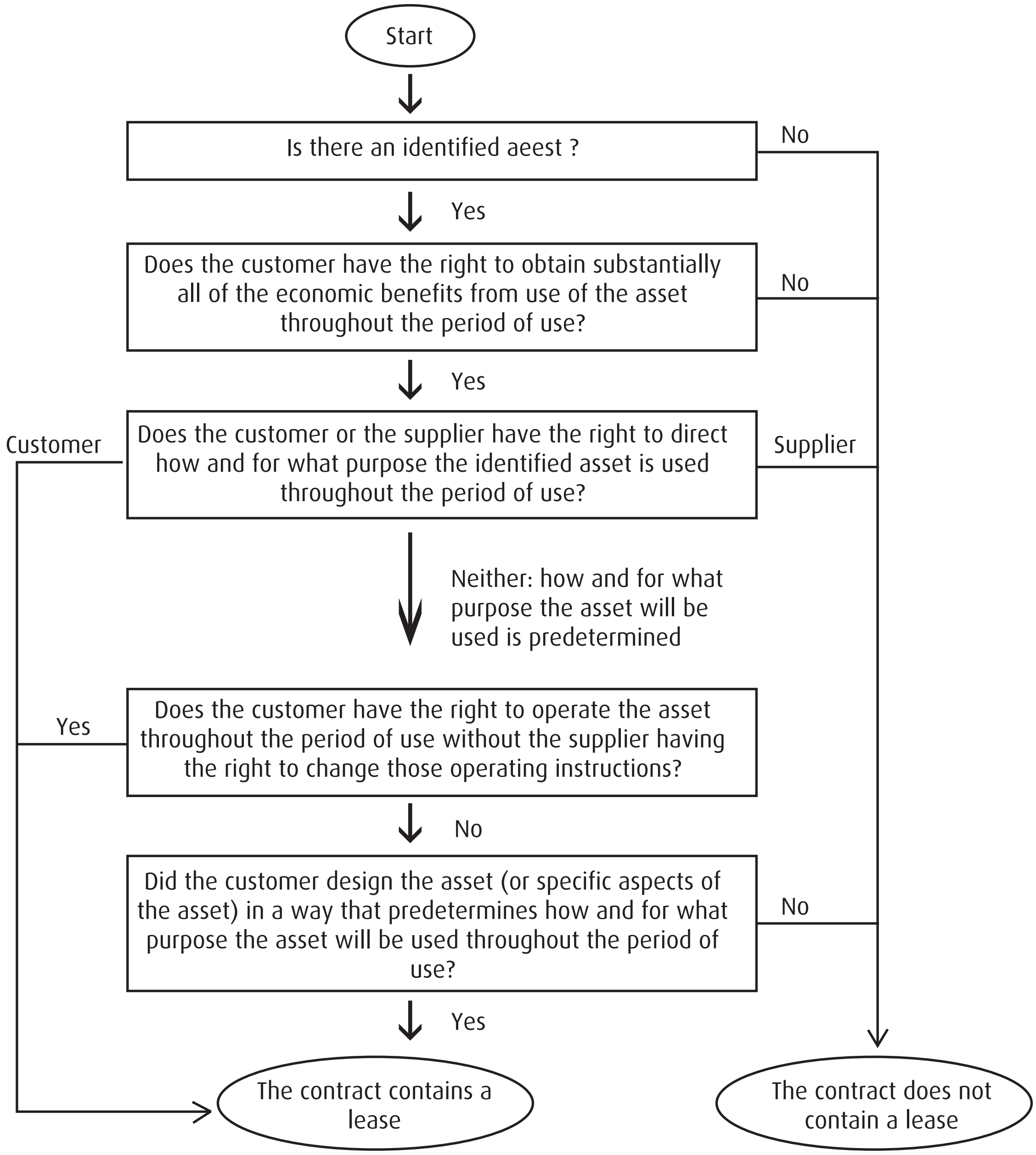
Substantive substitution right

Customer D enters into a contract with supplier E for the use of a floor of a building for a period of 5 years. Supplier E has given the right to arrange the floor area such as partitioning, fixing of equipment, cabling, etc. in a way it is able to use for Customer D's business. Customer D has to spend significant amount of money for the improvements. Does the supplier have the substantive substitution right in this contract?

A Analysis

It indicates that the supplier does not retain the substitution right with him since he has allowed customer D to arrange the floor area as customer D's requirements by spending of significant amount of money. Therefore this **contract contains a lease**.

Flowchart



3.2.3 Identifying and separating lease and non-lease components of a contract and allocate contract consideration

3.2.3.1 Identifying and separating lease and non-lease components

For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient indicated in the paragraph 15 of SLFRS 16.

The right to use an underlying asset is a separate lease component if both:

(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets.

Practical Expedient – Lessees

As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of SLFRS 9 Financial Instruments.

Eg: Example 06

Identifying and separating lease components

Scenario A

A local trucking company enters into a lease of a warehouse and the surrounding car park that is used for deliveries and truck parking. This warehouse will be used as the hub for its shipping operations.

A Analysis

The lessee will not be able to benefit from the use of the warehouse without using the parking space. Therefore, warehouse is dependent upon the parking space. Hence the contract contains **one lease component**.

Eg: Example 07

Identifying and separating lease components

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional plot of land that is adjoining to the car park. This plot of land could be developed by the lessee for other uses (e.g. to construct a truck maintenance facility).

Analysis

Contract includes **two lease components**. A lease of the warehouse together with parking space can be considered as one lease component. The adjoining land can be developed for other uses independent of the warehouse and parking space. Hence it has to be considered as separate lease component.

Example 08

Identifying and separating lease from non-lease components

Customer A leases a building from supplier B. Supplier B agrees to provide maintenance services and cleaning service with the garbage removable.

Analysis

If the customer does not decide to apply the practical expedient – lease of the building is the lease component and the providing of maintenance services and the cleaning service is the non- lease component.

If the customer decides to apply the practical expedient – The customer does not separate the lease component from the non-lease component and account it as a single lease component.

Under SLFRS 16, payments for maintenance activities such as providing utilities or cleaning services are considered as non-lease components because they are related to the providing of service for the lessee.

3.2.4 Allocate contract consideration

Lessee

For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non- lease components.

The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximizing the use of observable information.

Lessor

For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor is required to apply SLFRS 15 to allocate the consideration between the lease and non-lease components on a relative stand-alone selling price basis. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price.

3.2.5 Lessee Accounting

3.2.5.1 Short term leases and low value assets

For short term leases and leases of low value assets, a lessee may elect not to recognize the right of use an asset derived from such lease contracts together with the liability to make lease payments thereon.

Short term leases

A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

Eg: **Example 09**

Short term lease

A lessee enters into a lease with a 10-month non-cancellable term with an option to extend the lease for further 5 months. The lease does not have a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below the market rates.

A **Analysis**

The lease term is greater than 12 months (i.e., 15 months). Therefore, the lessee should not account for the lease as a short-term lease.

Leases of low value assets

A lessee shall assess the value of an underlying asset based on the value of the asset when it is new regardless of the age of the asset being leased. Examples of low value assets include desktop and laptop computers, small items of office furniture, telephones and other low value equipment.

An underlying asset can only be of low-value if:

- The lessee can benefit from use of the assets on their own, or together with, other resources that are readily available to the lessee; and
- The underlying asset is not dependent on, or highly interrelated with, other assets.

3.2.5.2 Initial Measurement

Right of Use assets

At the commencement date, a lessee shall measure the right-of-use asset at cost.

The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability;

(b) any lease payments made at or before the commencement date, less any lease incentives received

(c) any initial direct costs incurred by the lessee; and

(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

Lease Liability

At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

(a) fixed payments, less any lease incentives receivable;

(b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;

(c) amounts expected to be payable by the lessee under residual value guarantees;

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Discount Rate

Lessee – lease payments are discounted using the **interest rate implicit** in the lease if that rate can be readily determined. If that rate cannot be readily determined, the lessee's **incremental borrowing rate** should be used.

Eg: Example 10

Lessee Accounting

Entity A enters into a three year period lease of an equipment. Entity A agrees to make the following annual payments at the end of each year: Rs.20, 000 in year one, Rs.22, 000 in year two and Rs.25, 000 in year three. For simplicity, assume that there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). Entity A uses its incremental borrowing rate of 10% because the interest rate implicit in the lease cannot be readily determined. Entity A depreciates/amortized the right-of-use asset on a straight-line basis over the lease term.

A Answer

Initial measurement of Right of Use Asset

		Rs.
Initial measurement of the lease liability	(Note 1)	55,145
Advance paid at the commencement		-
Initial Direct Cost		-
Estimate cost for dismantling and removing		55,145

Note 01 : Initial measurement of the lease liability

Year	Cash Flow	Discounting Factor	Present Value
1	20,000	0.909	18,181
2	22,000	0.826	18,181
3	25,000	0.751	18,783
			55,145

$$\text{Discounting Factor} = \frac{1}{(1 + r)^n}$$

Journal Entry for Initial Recognition

Right of use the Asset	Dr	55,145	
Lease Liability			55,145

Recording of Expenses

Lease Amortization Schedule

Year	Lease Value	Interest @ 10%	Payment	Balance
1	55,145	5,515	(20,000)	40,660
2	40,660	4,067	(22,000)	22,727
3	22,727	2,273	(25,000)	-

Right of Use (ROU) amortization Schedule

Year	Opening Balance	Amortization per year	Closing Balance
1	55,145	18,382	36,763
2	36,763	18,382	18,382
3	18,382	18,382	-

Journal Entries for expense recording – Year 01

Interest on lease

Interest Expenses	Dr	5,5155	
Lease Liability			5,5155

Payment of Lease Rental

Lease Liability	Dr	20,000	
Cash			20,000

Amortization of Lease

ROU Amortization	Dr	18,382	
Right of use the Asset			18,382

Right of use the Asset

Lease Liability	55,145	Amortization	18,382
		Balance C/fd	36,763
	55,145		**55,145**

Lease Liability

Cash	20,000	Right of use the Asset	55,145
Balance C/fd	40,660	Lease Interest	5,515
	60,660		**60,660**
		Balance B/fd	40,660

Lease Interest

Lease Liability	5,515	P/L	5,515
	5,515		**5,515**

Cash

		Lease Liability	20,000

Right of Use Amortization

Lease Liability	18,382	P/L	18,382
	18,382		**18,382**

Extractions from Financial Statements

Statement of Financial Position

Non-Current Asset	**(Rs.)**
Right to use the Asset/ Leased Asset	36,763
Non- Current Assets	
Lease Liability (25,000-2,273)	22,727
Current Liabilities	
Lease Liability (22,000-4,067)	17,933

Statement of Compressive Income

Expenses	**(Rs.)**
Right to Use Amortization	18,382
Lease Interest	5,515

3.2.5.3 Subsequent Measurement

Right of Use Assets

After the commencement date, a lessee shall measure the right-of-use asset applying a cost model. However, if the lessee applies;

- The fair value model in LKAS 40 Investment Property to its investments property, the lessee should also apply the fair value model to right of use assets that meets the definition of investment property in LKAS 40,.
- The revaluation model in LKAS 16 to its class of property, plant and equipment, the lessee may elect to apply the revaluation model to all the right of use assets which are belong to same class of property plant and equipment.

Lease Liability

After the commencement date, a lessee shall measure the lease liability by;

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) remeasuring the carrying amount to reflect any assessment or lease modifications, or to reflect in-substance fixed lease payments.

3.2.6 Lessor Accounting

A lessor shall classify each of its leases as either an operating lease or a finance lease. A lease is classified as a finance lease, if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Risk and rewards could be understood using the following table.

Risks	Rewards
Losses on assets due to decrease in demand	profits expected to be generated using the assets
Losses on decreasing the demand due to technological obsolescence.	Profit expected to be generated through selling of an asset.
Losses due to maintenance and repairs of assets	Increase in future market prices of the asset.
Tax charge on assets subsequently and incur losses on tax payments.	Gains arising from the tax benefit.

Classification of Lease Arrangements

Whether ownership of the asset is transferred to lessee after lease period? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether the lessee has the option to purchase the asset at reasonable price? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether lease term is major part of economic life of the asset? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether the present value of the minimum lease payments is equal to fair value of the asset? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether asset can be used by lessee without major modification? ⇨ Yes ⇨ Finance Lease

⇩ No

If the lessee can cancel the lease whether the lessor's losses associated with the cancellation are born by the lessee? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether gains of losses from fluctuations in the fair value of the residual amount accrue to the lessee? ⇨ Yes ⇨ Finance Lease

⇩ No

Whether the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than the market value? ⇨ Yes ⇨ Finance Lease

⇩ No

An operating Lease ⇨ Yes ⇨ Finance Lease

3.2.7 Finance Lease

At the commencement date, a lessor shall recognize assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Initial Measurement

The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease.

At lease commencement, a lessor accounts for a finance lease, as follows;

- Derecognises the carrying amount of the underlying asset
- Recognises the net investment in the lease
- Recognises, in profit or loss, any selling profit or selling loss

Subsequent Measurement

A lessor shall recognize finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.

Discount Rate

Lessor – The discount rate for the lease is the interest rate implicit in the lease, which is the rate that causes the following.

Present value of the lease payments made by the lessee for the right to use the underlying asset	+	Present value of the unguaranteed residual value	=	The fair value of the underlying asset	+	Any initial direct costs of the lessor

Eg: Example 11

Lessor enters into a five year period lease of an equipment. Under the lease, lessor receives annual lease payments of Rs. 25,000/- at the end of each year. Lessor expect the residual value of the equipment is Rs. 20,000/-. Lessee provides a residual value guarantee of Rs. 12,000/- at the end of the lease term. Interest rate implicit in the lease is 12.542%. Carrying value of equipment is Rs. 80,000/-

i) Calculate the gross investment in the lease

ii) Calculate the net investment in the lease

iii) Calculate the unearned finance income

iv) Calculate the selling profit or loss

v) Mention the relevant journal entries for the initial recognition and the relevant journal entries for the 1st year.

Answer

(i) Gross investment in the lease

Lease rentals for five years + Guaranteed residual value + Unguaranteed residual value

(25,000 x 5) + 12,000 + 8,000 = **145,000/-**

Year	Cash Flow	Unguaranteed R.V.	Total Cash Flow	12.542% Discounting Factor	Present Value
1	25,000		25,000	0.889	22,214
2	25,000		25,000	0.790	19,738
3	25,000		25,000	0.702	17,539
4	25,000		25,000	0.623	15,584
5	37,000	8,000	45,000	0.554	24,925
					100,000

Discounting Factor = $\frac{1}{(1 + r)^n}$

Discounting Factor = $\frac{1}{(1 + 12.542\%)^1}$

(ii) Net investment in the lease (present value of the gross investment in the lease)

Net Investment in the lease = Rs. 100,000/-

(iii) Unearned Finance Income

The difference between the gross investment in the lease and the net investment in the lease

Rs. 145,000 – Rs. 100,000 = Rs. 45,000/-

(iv) Selling profit or loss

Net Investment in the lease = Rs. 100,000/-

Carrying Value of equipment = Rs. 80,000/-

Profit / (loss) on sale = Rs. 20,000/-

Initial Journal Entries will be as follows for the initial recognition

Net Investment in the lease (Lease Receivable)	Dr. 100,000	
Property, plant & equipment / Property held for Lease		80,000
Gain on the transaction		20,000

(v) First year journal entry in lessor's books

Cash	Dr. 25,000	
Net Investment in the lease		12,458
Interest Income		12,542

Workings

12.542%					
Year	**Lease Receivable - Opening Balance**	**Annual Interest**	**Installment**	**Capital Repayment**	**Lease Receivable - Closing Balance**
1	100,000	12,542	25,000	12,458	87,542
2	87,542	10,980	25,000	14,020	73,522
3	73,522	9,221	25,000	15,779	57,743
4	57,743	7,242	25,000	17,758	39,985
5	39,985	5,015	45,000	39,985	-

3.2.8 Operating Lease

Recognition and measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense.

A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

Exercises on Lease

(1) Lessee has entered into an agreement with Lessor to use a building on rent from the date of 1st March 2019 to 28th February 2024 and lease rental shall be paid on 30th day of each month starting from March 2019. Lessor agreed to make the building available from 1st February 2019 to arrange the space before start the operation. What is the lease commencement date? What is the lease period?

(2) A customer enters into 2 years contract with a supplier for the right to use of a truck. What are the facts that you should consider in determining whether the arrangement contains a lease?

(3) What are the criteria need to be satisfied to identify that the lessee has the right to control the use of the identified asset?

(4) The lessee has entered into an agreement with the lessor to use an asset for 10 months period and there is an option given to renew the contract for further 10 months with an adjustment to the monthly rental value based on the market rates. The lessee is not reasonably certain to exercise this renewal option since there is a revision in the rental values. Will you recognize this as a lease in the books of accounts?

(5) A Ltd. obtained a building under a lease agreement for a 3 year period. Lessor will increase rental value by 10%, if there is an increment in the market prices during the lease term. Is this a finance lease or an operating lease?

(6) A Ltd. acquired an asset under lease agreement and lease period is 5 years. A Limited could be owned the asset at the end of the lease period, after paying 70% of market value of asset within the 5 years. Is this a finance lease or an operating lease?

(7) What is the accounting treatment in terms of lessor accounting at the lease commencement date, under finance lease?

Solutions

(1) Lease commencement date is the date on which the lessor makes an underlying asset available for use by the lessee. Even though the cash payments are starting from March 2019 onwards, the commencement date of the lease is 1st February 2019. Lease period is starting from 1st February 2019 to 28th February 2024 (5 years and 1 month).

(2) - Whether the truck is an identified Asset

- Whether the supplier has the practical ability to substitute the asset and make benefits from substituting the asset or whether the customer has the right to obtain the substantially all of the economic benefits from use of the asset.

- Whether customer has the right to direct how and for what purpose the truck is used

(3) The lessee has the right to obtain substantially all the economic benefits of the asset plus right to direct the use of the underlying asset.

(4) Since there is an uncertainty of exercising the renewal option, the lease term is 10 months. Therefore this can be considered as a short term lease and there is no requirement to recognize this arrangement as a lease in the books of accounts. It is exempted under SLFRS 16.

(5) This is an operating lease. Benefit from future price increase of the asset is taken by lessor and risks and rewards of the ownership of asset are not transferred to lessee.

(6) This is a finance lease. Lessee can take the asset less than market value during the lease period.

(7) - Derecognize the carrying amount of the underlying asset
- Recognize the net investment in the lease (lease receivable)
- Recognize any selling profit or loss in the income statement