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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL 02 – Financial Reporting and Governance

Corporate Level

(SLFRS 16 – P1)

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SLFRS 16 - Leases

Topic No 07

Objective

SLFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases. The **objective** is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. Below is a summary of what we have to learn.

Introduction
- Definitions
- Scope
- Identifying a lease
- Non-lease components
- Lease term

Accounting for Lessee
- Exemptions
- Recognition
- Initial messurement
- Subsequent measurement
- Lease modifications

Accounting for Lessor
- Lease classfication
- Operating leases
- Finance leases

Sale and Lease Back
- Sale under SLFRS 15
- Sale not under SLFRS 15

1. INTRODUCTION

1.1 LEASES MEANS

Lease	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. **(Definition)**
	Rather going for an outright purchase through a lease the lessee (party that gets the right to use) can obtain right of using that asset for a specific period from lessor (the owner of the asset) in exchange of payments.
Sub-lease	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. **(Definition)**
	<u>Example</u> Company X enters into a five-year lease for 5,000 square meters of office space (the head lease) with Company Y (the head lessor). At the beginning of Year 3, X sub-leases the 5,000 square meters of office space for the remaining three years of the head lease to Company Z.

1.2 SCOPE

SLFRS 16 shall be applied to all leases including subleases except for:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- leases of biological assets within the scope of LKAS 41
- service concession arrangements within the scope of IFRIC 12
- licenses of intellectual property granted by a lessor within the scope of SLFRS 15
- Rights held by lessees under licensing agreements (motion picture films, patents, copyrights, etc.)

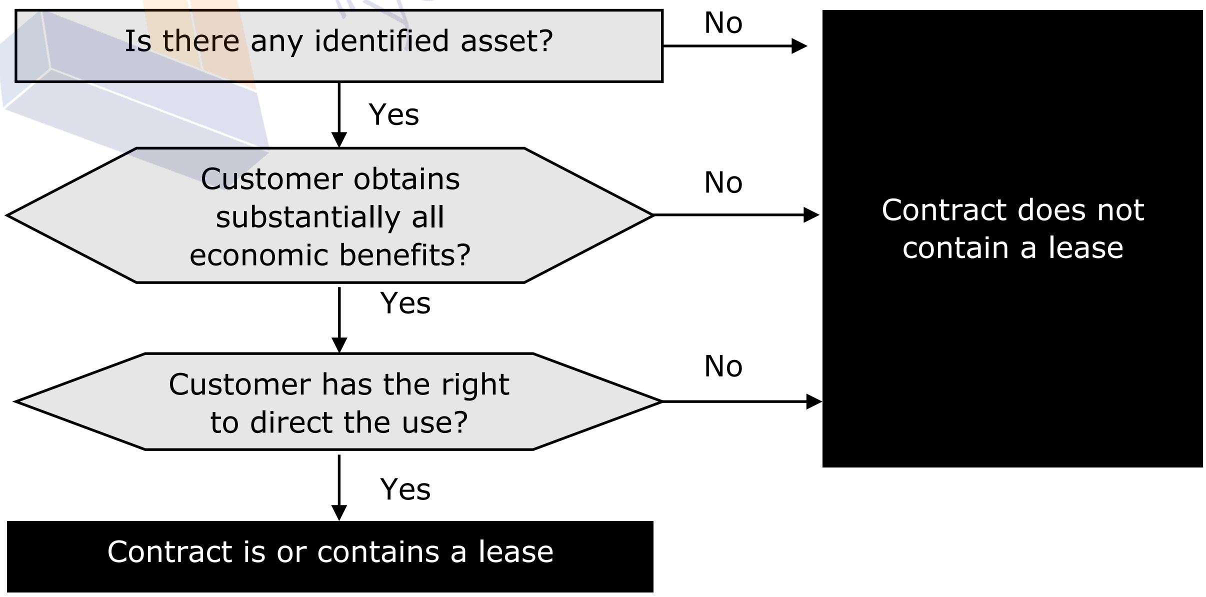
However, for **other intangible assets** an entity **may apply SLFRS 16**. But it is not required to.

1.3 IDENTIFYING A LEASE *(Para 09)*

SLFRS 16 states that 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. Therefore, as per **paragraph 09 at inception of a contract**, an entity **shall assess whether** the contract is, or contains, **a lease**. Further, an entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

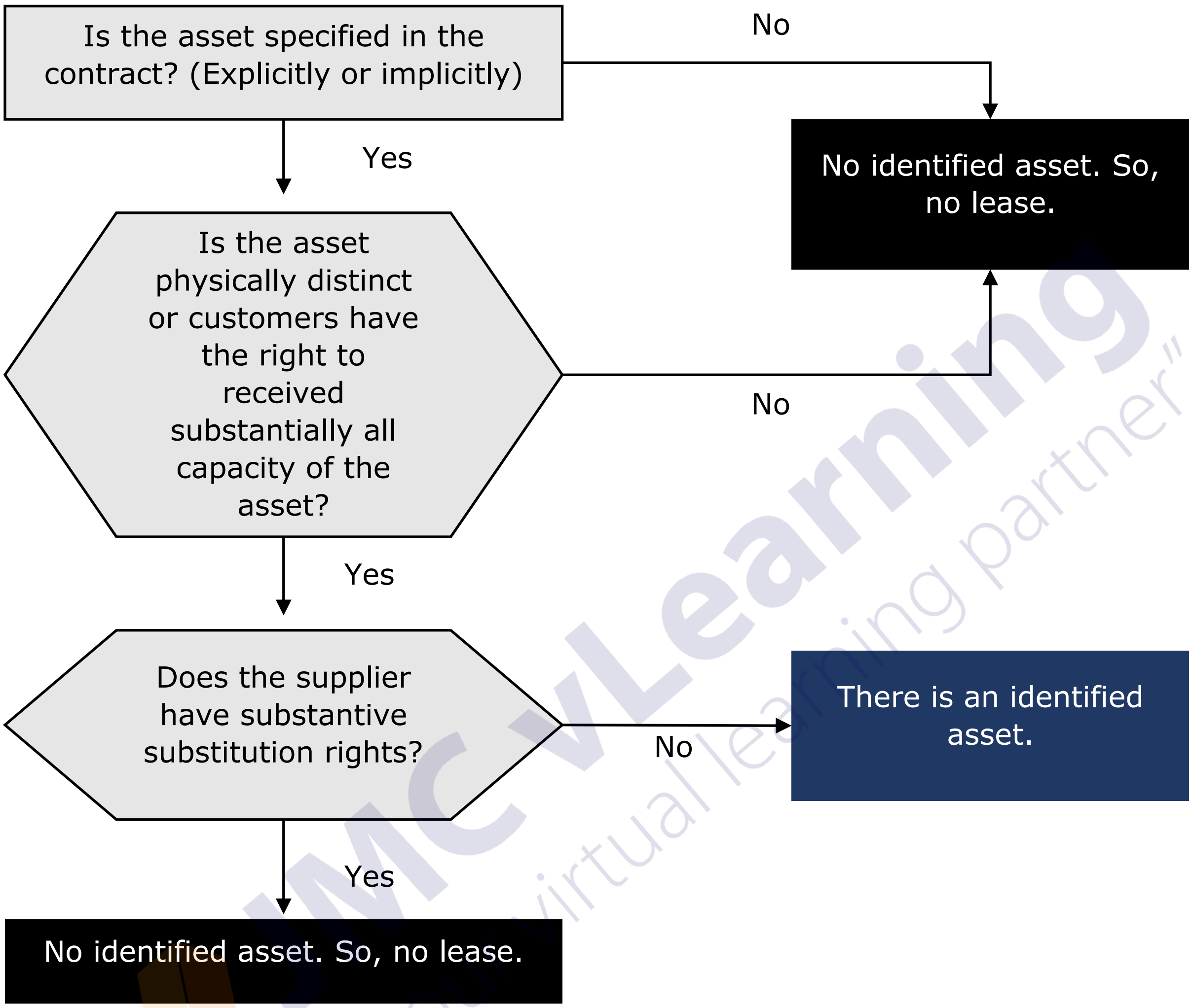
Inception date of a lease	**Earliest** date of: • Lease agreement date • The date of commitment by the parties to the principal terms and conditions of the lease

The definition can be applied as follows to assess whether a contract contains a lease.



C1 – Identified Asset

A contract contains a lease only if it relates to an identified asset. Using below flowchart it can be assessed whether there is an identified asset.



Specified Asset (1st point)

An asset can be either **explicitly specified** in a contract (e.g. by a serial number or a specified floor of a building) or **implicitly specified** at the time it is made available for use by the customer.

Explicitly specified	**Implicitly specified**
In the lease contract the asset is clear distinguished and specified.	An asset will be implicitly identified when the supplier can fulfil its obligations only by using a specific asset.
Ex: 1. In a motor vehicle lease the agreement specify the asset by mentioning the vehicle no, colour, engine no etc.	Ex: 1. Supplier is having only one asset that can fulfil the obligations of the agreement.

2. In a lease of a land mentioning the extent, location, border etc.	2. Supplier has multiple assets with required functionality but if only one of those assets can be realistically supplied to the customer.

Is the asset physically distinct or customers have the right to received substantially all capacity of the asset? (2nd point)

If an asset (a full asset not a portion) is explicitly identified or implicitly identified in the contract, then that asset will be physically distinct from each other. However, a problem arises on being physically distinct, when the **portions of asset** are being leased/rented.

How to conclude capacity portions as identified assets or not?

If capacity portion is physically distinct	**If the customer has the right to receive substantially all of the capacity of the asset**
Ex: 1. a specific floor of a building 2. a specified strand of a fibre-optic cable 3. a distinct segment of a pipeline	Ex: 1. a capacity portion of a fibre - optic cable that is not physically distinct but represents substantially all of the capacity of the cable

Capacity portion **might not always be an identified asset**.

Ex:

- When a customer gets 60% of a storage tank that the portion cannot be physically separated. Further, 60% does not represent substantially all the capacity.

Storage tank

Substantially all means?	• SLFRS 16 does not define this. • However, in lessor determining whether a lease is a finance or operating lease US GAAP allows to use but not required a 90% threshold. • Companies shall develop their own interpretation.

Does the supplier have substantive substitution rights? (3rd point)

Even if an asset is specified in a contract, a customer does not control the use of an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset.

Such a right exists **if the supplier** (both following):

Has the practical ability to substitute the asset throughout the period of use	**Would benefit economically from exercising its right to substitute the asset**
This is possible when the **customer cannot prevent it** from substituting the asset and the **supplier has alternative assets either readily available** or available within a reasonable period of time.	This happens when the **economic benefits** associated with substituting the asset are expected to **exceed the related costs**. The costs associated with substitution are generally higher if the asset is not located at the supplier's premises.

However, there is **no practical ability to substitute the asset** throughout the period of use (and therefore there is no substantive substitution right) if the substitution right applies,

- Only to a part of the period of use
- Only at or after a specific date
- Only on the occurrence of a particular event

Period of use	• Total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

Question 01 – Substantive Substitution Right		
Scenario 1	**Scenario 2**	**Scenario 3**
Customer S enters into a contract with Supplier T for the right to use a motor vehicle for five years. T has the right to substitute the asset at any time after three years from the commencement of the contract (i.e. *No substitution right for the first three years*).	The contract is the same as above except that it gives T the right to substitute the identified asset on a single date, three years into the lease, but not at any other time.	The contract is as above but T has a right to substitute on the occurrence of a particular event.
Not substantive as substitution right does not apply throughout the period of use,	**Not substantive** because it does not apply throughout the period of use.	**Not substantive** because it does not apply throughout the period of use but only on the occurrence of a particular event.

Below is **not a substantive substitution right.**

- A supplier's right or obligation to substitute the asset **for repairs and maintenance**, because the asset is not working properly – i.e., a 'warranty-type' obligation – or because a technical upgrade becomes available.

C2 - Economic benefits from using the asset *(B21)*

To determine whether a contract conveys the right to control the use of an identified asset, a company assesses whether the customer has the rights to:– **obtain substantially all of the economic benefits from use** of the identified asset **throughout the period of use**; and– direct the use of the identified asset throughout the period of use.

The economic benefits can be attributed to the subjected asset's:

- primary output
- by-products
- realization from any other commercial transaction Ex: subleasing the asset

Example:

C has leased a solar power plant for 20 years of period and can obtain economic benefits as follows over the said 20 years (period of use)	
Through primary output	Through by-products
Electricity produced by the farm over the lease term	Renewable energy credits

It is important to note that if there are any restrictions on the scope of usage, then the **benefits need to be within the scope**. Out of scope benefits shall be excluded.

For example: If the contract limits the territory that the underlying asset can operate then the benefits shall be taken into account that are derived within that territory.

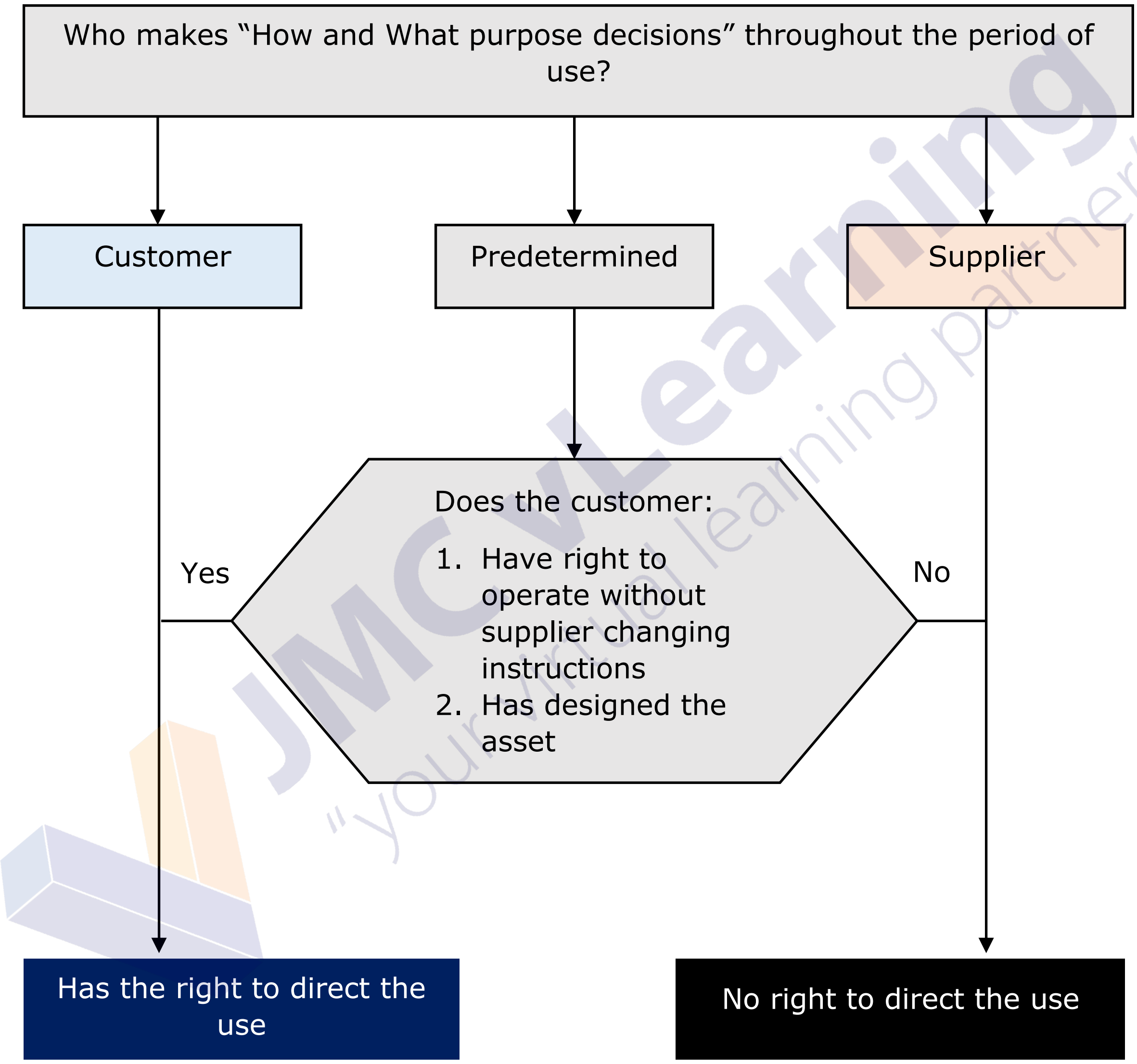
C3 – Right to direct the use *(B24)*

A customer has the right to direct the use of an identified asset in either of the following situations:

- The **customer has the right to direct** how and for what purpose the asset is used throughout the period of use
- The **relevant decisions** about how and for what purpose the asset is used are **predetermined** and either:

- The customer has **the right to operate the asset** (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions ***or***
- The **customer designed the asset** (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Below diagram summarizes the right to direct the use.



What are "How and What Purpose" Decisions?

In assessing who has the right to direct **how** and **for what purpose** the asset is used, a company considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used. Decision-making rights are '**relevant'** when **they affect the economic benefits** derived from use.

Type of decision	Description	Example
What	Rights to change the type of output that is produced	Deciding whether to use a shipping container to transport goods or for storage
When	Rights to change when the output is produced	Deciding when a power plant will generate power
Where	Rights to change where the output is produced	Deciding on the destination of a truck or a ship
Whether and how much	Rights to change whether the output is produced, and the quantity of that output	Deciding whether to produce energy from a power plant and how much energy

What if the decisions are pre-determined?

If the decisions are pre-determined within the contract the customer will get control only if either of the following is present.

- the customer has the right to **operate** the asset
- the customer **designed** the asset

Question 02 – Pre-determined decisions on use

Identify in below 02 scenarios whether the customer gets the right to direct the use of underlying asset.

Scenario 1	Customer R enters into a contract with Supplier S, a ship owner, for the transport of cargo from A Coruña to Hartlepool on an identified ship. The contract details the cargo to be transported on the ship and the dates of pick-up and delivery. The cargo will occupy substantially all of the capacity of the ship. S operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. R is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.
Scenario 2	Customer C enters into a 20-year contract with Energy Supplier E to install, operate and maintain a solar plant for C's energy supply. C designed the solar plant before it was constructed – C hired experts in solar energy to help in determining the location of the plant and the engineering of the equipment to be used. C has the exclusive right to receive and the obligation to take all energy produced.

What if there are protective rights to the supplier?

A contract may include certain terms and conditions designed to protect the supplier's interest in the identified asset or other assets. These protective rights **typically define the scope** of the right to use an asset **but do not,** in isolation, **prevent** the **customer** from **having the right to direct the use** of the asset within that scope.

For example, a contract may:

- Specify the **maximum amount** of use of an asset or where or when the customer can use the asset;
- Require a customer to **follow particular operating practices**;
- Require a customer to **inform the supplier of changes** in how an asset will be used.

Question 03 – Lease Contract

Customer enters into contract with Supplier for two years for exclusive use of a specified truck to transport cargo from New York to San Francisco. Contract prohibits Supplier from substituting alternative truck. Cargo to be transported, timing and location of pick-up in New York and delivery in San Francisco are specified in contract. Customer is responsible for driving truck from New York to San Francisco.

Required to **identify** whether this contract contains a lease?

Question 04 – Lease Contract

Big Farm has the use of two combine harvesters under a contract from Agrirental Ltd. The contract agrees that Bif Farm ltd will have access to combine harvesters which have VARIO cutters. However, Agrirental can decide on the brand and specific machine supplied to Big Farm albeit with VARIO cutters. As the harvesting is not a year-round activity, Agrirental retains the combine harvesters at its depot, but will supply them as requested within 24 hours.

Required to **identify** whether this contract contains a lease?

Question 05 – Lease Contract

Kabal enters into a ten-year contract with a utilities company (Telenew) for the right to use three specified, physically distinct dark fibres within a larger cable connecting North Town to South Town. Kabal makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie

Kabal 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Telenew is responsible for the repairs and maintenance. Telenew owns extra fibres but can substitute those for Kabal's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

Required to **identify** whether this contract contains a lease?

1.4 SEPARATING COMPONENTS OF A CONTRACT *(para 12)*

If a contract is, or contains, a lease, then a company accounts for each separate lease component, separately from non-lease components.

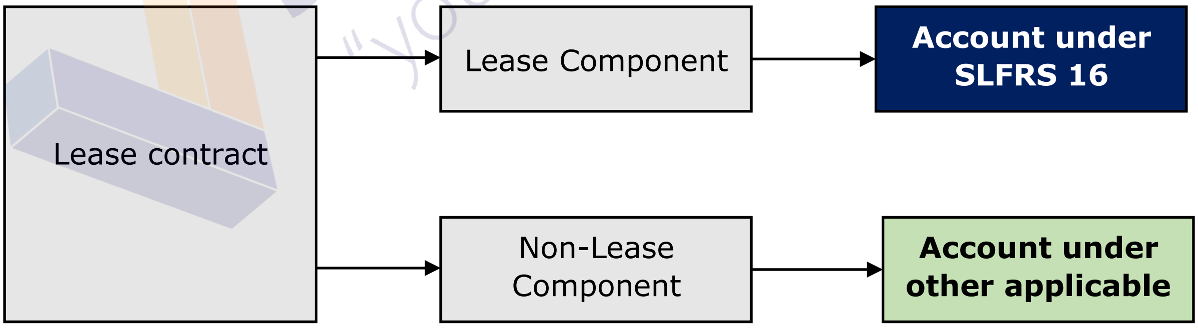
A contract may contain:

- Lease components
- Non-lease components (e.g.: an agreement to provide maintenance, repairs or cleaning)

It may also include other activities that are **not a component of the contract** (eg an agreement to pay a contract administrative fee).

A company considers the right to use an underlying asset as a **separate lease component** if it meets the following criteria:

- The lessee **can benefit** from using that underlying asset **either on its own** or together with other resources that are readily available; **and**
- The asset is **neither highly dependent** on, **nor highly inter-related with, the other assets** in the contract.



When separating the lease and non-lease components the total consideration need to be allocated for each component as follows.

Lesse (Customer)	Lessor (Supplier)
Based on relative stand-alone price	Based on relative stand-alone price in accordance with SLFRS 15

However, as a **practical expedient**, a **lessee** may elect, by class of underlying asset, to combine each separate lease component and any associated non-lease components and **account for them as a single lease component**. But, this practical expedient is **not available for a lessor**. A lessor always accounts for non-lease components separately from the lease components.

Question 06 – Separating Components

Livery Co leases a delivery van from Vanlease Co for three years at Rs. 200,000 per year. This payment includes servicing costs. Livery could lease the same make and model of van for Rs. 180,000 per year and pay Rs. 30,000 a year for servicing.

Required to **identify** how this agreement need to be treated as per SLFRS 16?

1.5 LEASE TERM *(para 18)*

The lease term is the **non-cancellable period of the lease**, together with:–

- **optional renewable periods** if the lessee is reasonably certain to extend; **and**
- **periods after an optional termination date** if the lessee is reasonably certain not to terminate early.

Termination options **held only by the lessor** are **not considered** when determining the lease term. To determine the lease term, a company first determines the length of the non-cancellable period of a lease and the period for which the contract is enforceable. It can then determine – between those two limits – the length of the lease term.

If there are no any optional renewable periods non-cancellable period will be equal to the enforceable period.

How to assess whether it will be reasonably certain that the options are exercised or not in respect of lease term?

- Based on the Economic Incentives relating to the lease.
  - *Examples*:
    - Contractual terms and conditions for optional periods compared with market rates.
    - Significant leasehold improvements undertaken or expected to be undertaken.
    - Termination costs
    - Importance of underlying asset to lessee's operations
    - Conditionality associated with exercising the option and likelihood that those conditions exist.

When to reassess the non-cancellable period?

After the commencement date, a company may reassess the lease term and options when:

Lessee

- A significant event or change in circumstances happens within lessee’s control
- A change in non-cancellable period

Lessor

- A change in non-cancellable period

Question 07 – Lease Term

Lessee W leases a shop from Lessor L. The lease has a non-cancellable term of five years, and W has the option to renew the lease for a further five years – i.e. the lease has a potential maximum term of 10 years. During Year 3, W undergoes significant rebranding – changing its logo, colour scheme and target market. At this time, W installs significant leasehold improvements, which include a store fascia, shelving and other branded material. Based on its experience at other stores, W believes that these materials have a useful life of 10 years once they are installed; they cannot be repurposed to other stores because they would be damaged in being removed.

Required:
Based on given information, assess how the lease term would have been assessed initially and reassessed subsequently.

2. ACCOUNTING FOR LESSEE

A lessee applies a **single lease accounting model** under which it recognizes all leases on-balance sheet, **unless it elects to apply the recognition exemptions.**

Statement of Financial Position	Statement of Profit or Loss
Asset: Right of Use Asset (ROUA) **Liability:** Lease liability (the obligation to make lease payments)	**Total expenses relating to lease:** • Finance Cost (Interest on lease liability) • Operating Expenses (Depreciation of ROUA)

2.1 RECOGNITION EXEMPTIONS FOR LESSEES (SIMPLIFIED ACCOUNTING)

A lessee can elect not to apply the lessee accounting model to:

- **Short Term Leases** - Leases with a lease term of 12 months or less that do not contain a purchase option.
- **Low Value Leases** - Leases for which the underlying asset is of low value when it is new: even if the effect is material in aggregate.

If a lessee elects to apply either of these recognition exemptions, then it recognizes the related **lease payments as an expense** on either a straight-line basis over the lease term, or another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

Application of the exemption:

Short Term Leases	Low Value Leases
Made by class (group in similar nature) of underlying asset	Applied on lease-by-lease basis
Can be applied to renewable or cancelable leases considering the certainty of exercising the option. After exercising if the lease term drags for more than 12 months, then cannot be applied.	Cannot be applied if the individual asset cannot benefit by it's own or if it is highly interdependent or interrelated with another asset. Further to a head lease if it is going to be subleased.

Question 08 – Simplified Accounting

Casey Recruitment Co (CRC) enters into the following lease arrangements in the year ended 31 December 2017:

1. An agreement to use 100 tablet computers for two years. Each tablet has a cash cost when new of Rs. 84,000 each.
2. An agreement to lease a module to increase the storage capacity of the mainframe server. The server was obtained through a lease arrangement in 2014. The module has a cash cost of Rs. 140,000.
3. An agreement to obtain use of additional office space for the duration of a customer contract. The lease term is 3 years, with a break clause at 12 months. CRC expects its contracted work for the customer to be complete within 12 months and therefore expects to exercise the break clause.

Required to **Explain** whether simplified accounting can be applied to these lease agreements.

Question 09 – Simplified Accounting

On 1 January 2013 Alahakoon entered into a lease contract to obtain the use of 7 tablet computers for its staff. The tablets would have cost Rs. 795,000 to buy outright. The terms of the lease agreement require an initial non-refundable deposit of Rs. 32,000 and then quarterly rentals of Rs. 28,000 paid in arrears.

Required:
Record the expense recognized in Alahakoon's financial statements in the year ended 31 December 2013 assuming that it elects to apply the recognition exemption.

Other available exemption	For the portfolio of leases with similar characteristics when the company reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this standard to the individual leases within that portfolio **can apply SLFRS 16 to the portfolio.**

2.2 RECOGNITION

At the **commencement date**, a lessee shall recognize a **right-of-use asset** and a **lease liability**.

Commencement Date	The date on which a lessor makes an underlying asset available for use by a lessee

Does ROUA meet the definition of an Asset and Lease Liability meets the definition of a liability as per conceptual framework?

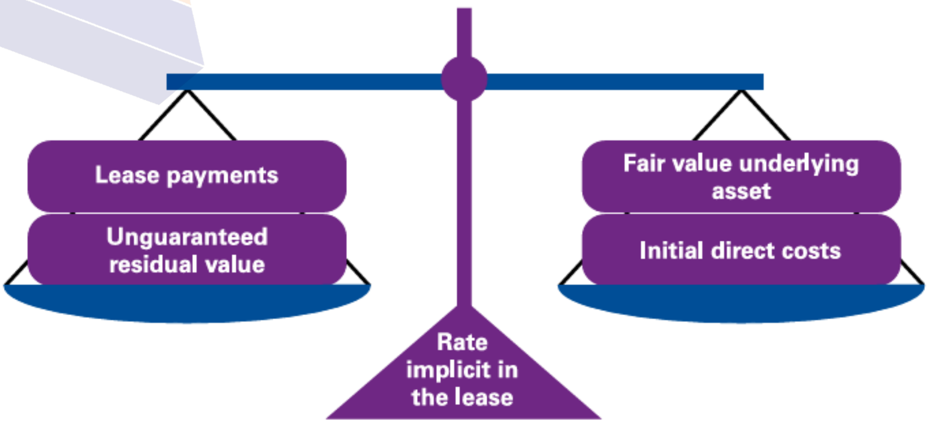
Right	**Control**	**Past Event**	**FEBs**	**Asset**
Right to use Underlying asset during lease term	Will get through Legally enforceable right established by lease contract	Signing of lease contract and delivery of asset	Yes	**Yes**
Obligation	**Control**	**Past Event**	**FEBs**	**Liability**
To make specified payments in the lease term	Legally enforceable obligation established by lease contract	Delivery of Asset	Yes	**Yes**

2.3 INITIAL MEASUREMENT

2.3.1 Initial measurement of lease liability *(Para 26)*

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**.

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.



- This is to be calculated in the point of view of lessor.

Lease payments include:

a) fixed payments (including in-substance fixed payments), less any lease incentives receivable.
b) variable lease payments that depend on an index or a rate.
c) amounts expected to be payable by the lessee under residual value guarantees.
d) the exercise price of a purchase option that the lessee is reasonably certain to exercise.
e) payments for terminating the lease if the lease term reflects early termination.

In-substance Fixed Payments

These are payments that are structured as variable lease payments, but that – in substance – are unavoidable. Examples include: –

- Payments that have to be made only if an event occurs that has no genuine possibility of not occurring.
- There is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic.
- There are multiple sets of payments that a lessee could realistically make, but it has to make at least one set of payments.

Example:

Lessee W leases a production line from Lessor L. The lease payments depend on the number of operating hours of the production line – i.e. W has to pay 1,000 per hour of use. The expected usage per year is 1,500 hours. If the usage is less than 1,000 hours, then W must pay 1,000,000. Here the 1,000,000 is an in substance lease payment even though it appears to be variable.

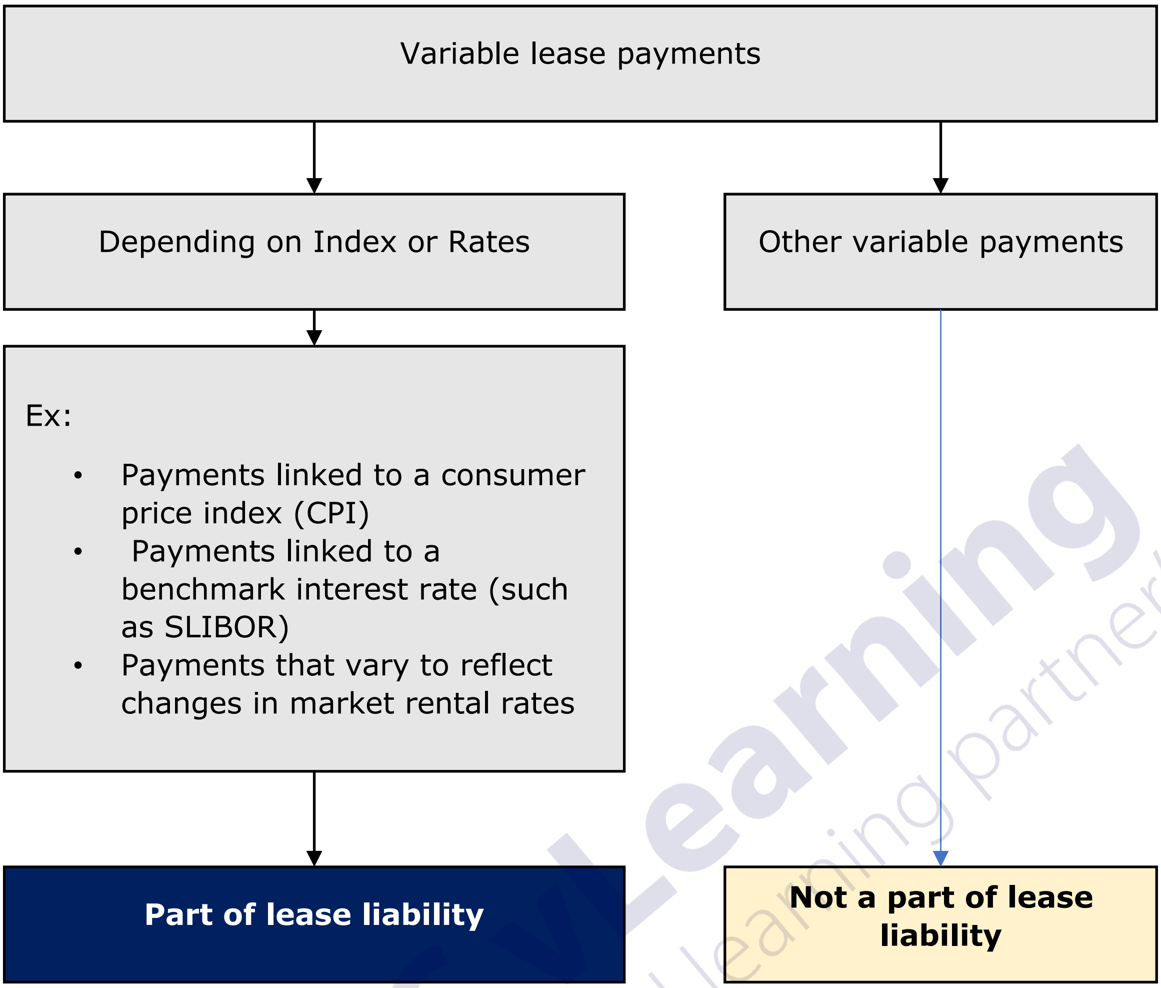
Variable Lease Payments

Refer the diagram below for better understanding.

Question 10 – Variable payments not depending on an index or rate

PNS enters into a 10-year lease for commercial space at 203, De Saram Place, Colombo 01 with the Landlord. The annual lease payments are SL Rs. 6,000,000/- plus an amount equal to 5% of PNS sales. PNS's annual sales have exceeded SL Rs. 9,000,000/- since it began operations and are projected to grow at a rate of 10% annually.

Required to identify what are the lease payments for purposes of measuring the lease?



Question 11 – Variable payments depending on an index or rate

Lessee Y rents an office building. The initial annual rental payment is 2,500,000. Payments are made at the end of each year. The rent will be increased each year by the change in the consumer price index (CPI) over the preceding 12 months. Assume that inflation rate was 5% during the first year.

Required to explain how the lease payments are accounted as per SLFRS 16?

Amounts to be Payable under Residual Value Guarantee

Residual value is the value of the underlying asset at the end of the lease term. The supplier (lessor) will receive the lease rentals over the period and at the end of the lease term get the asset back (in most cases). This residual value can be guaranteed or unguaranteed.

Guaranteed Residual Value (GRV)	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.
Unguaranteed Residual Value (UGRV)	That portion of the residual value of the underlying asset, the realization of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

Simply when the lessee (or a third party unrelated to lessor) makes a guarantee on the residual value, if the value of the underlying asset falls below the guaranteed amount, the difference will be required to be paid by lessee. Therefore, such an expected shortfall in value which is guaranteed is included in the lease liability calculation.

Question 12 – Residual Value Guarantees

Lessee Z has entered into a lease contract with Lessor L to lease a car. The lease term is five years. In addition, Z and L agree on a residual value guarantee – if the fair value of the car at the end of the lease term is below 400, then Z will pay to L an amount equal to the difference between 400 and the fair value of the car. The lessee expects that fair value of the car at the end of the lease term to be 380.

Required to identify the amount to be included as a lease payment.

2.3.2 Initial measurement of Right of Use Asset *(Para 24)*

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

The amount of the initial measurement of the lease liability	XXX
+ Lease payments made at or before the commencement date	XXX
+ Initial direct costs incurred by the lessee	XXX
+ Estimated costs to dismantle or restore (under LKAS 37)	XXX
- Lease incentives received	(XXX)
Initial Cost of ROUA	**XXX**

Initial Direct Costs

Include	Exclude
• Commissions • Legal Fees • Costs of arranging collateral • Costs that are incremental and directly attributable to negotiating lease terms and conditions	• General overheads (e.g. costs incurred by a sales and marketing team or a purchase team). • Costs of investment appraisals, feasibility studies, due diligence etc that are incurred regardless of whether the lease is entered into. • Costs to obtain offers for potential leases.

Estimated dismantling and restoration costs

This includes any costs which the lessee will have to incur for dismantling and removing the underlying asset or restoring the site at the end of the lease term. This is considered to the initial cost **only if at the commencement date that entity has a present obligation to restore**. Measured under principles of provisions given in LKAS 37.

Accounting entries for initial recognition

Debit	ROUA	
Credit	Lease Liability	
Credit	Cash	(Lease payments before commencement + initial direct costs – cash lease incentives received)
Credit	Dismantling and restoration provision	(Present value of expected dismantling and restoration costs)

Question 13 – Initial Measurement

On 1 January 2021, Dynamic entered into a three-year lease for a lorry. The contract contains an option to extend the lease term for a further 2 years. Dynamic believes that it is reasonably certain to exercise this option. Lorries have a useful life of ten years.

Lease payments are Rs.10,000 per year for the initial term and Rs.15,000 per year for the option period. All payments are due at the end of the year (Payment in arrears). To obtain the lease, Dynamic incurs initial direct costs of Rs.3,000. The interest rate within the lease is not readily determinable. Dynamic's incremental rate of borrowing is 5%.

Required:

1. **Calculate** the initial carrying amount of the lease liability and the right-of use asset and provide the double entries needed to record these amounts in Dynamic's financial records.

2. Show how the initial measurement changes **if the payments are due at the beginning of the year** (Payment in advance).

2.4 SUBSEQUENT MEASUREMENT

2.4.1 Subsequent measurement of lease liability *(Para 36)*

In accordance with SLFRS 16 the lease liability need to be subsequently measured as follows.

Lease liability at the year beginning	XXX
+ Interest on lease liability	XXX
- Lease payments made during the year	(XXX)
Lease Liability at the year end	**XXX**

Total Finance Charge

	Rs.
Total Lessee's lease payments	XXX
Amount on initial recognition	(XXX)
Total finance charge	**XXX**

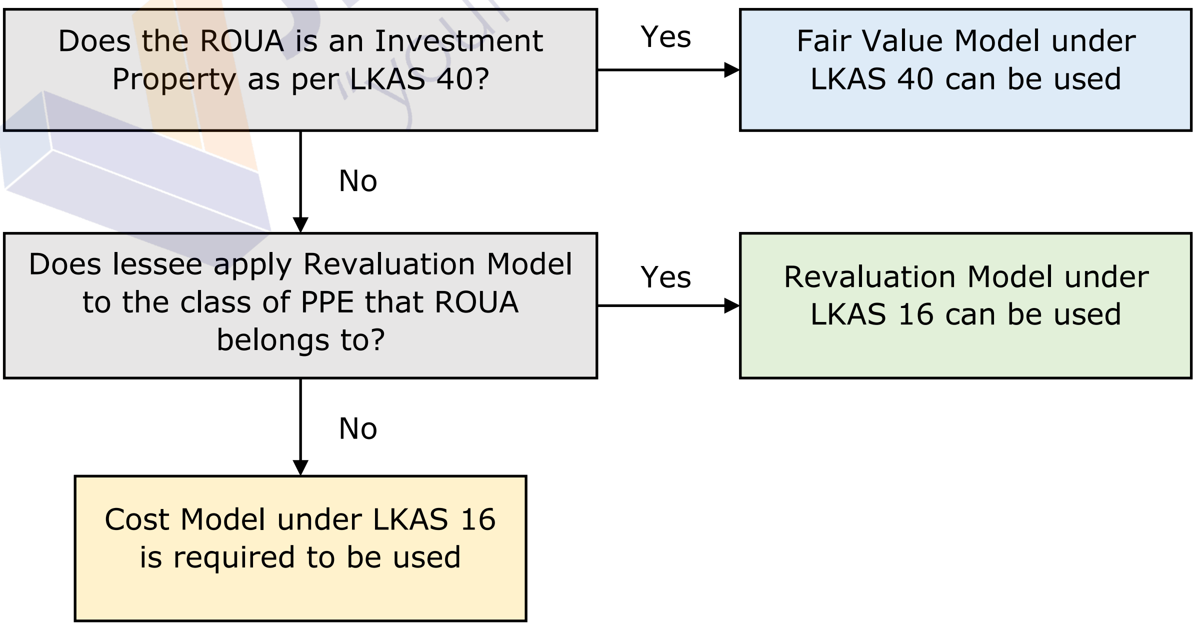
This total finance charge will be recognized over the lease term using effective interest method.

The year-end lease liability is required to distinguish between the current and non-current portions.

Current Liability	Next year lease payment less next year lease interest
Non-current Liability	Total lease liability less current liability

2.4.1 Subsequent measurement of ROUA *(Para 29)*

After the commencement date the right-of-use asset should be measured using the **cost model in LKAS 16**, unless it is an investment property or belongs to a class of assets to which the revaluation model applies.



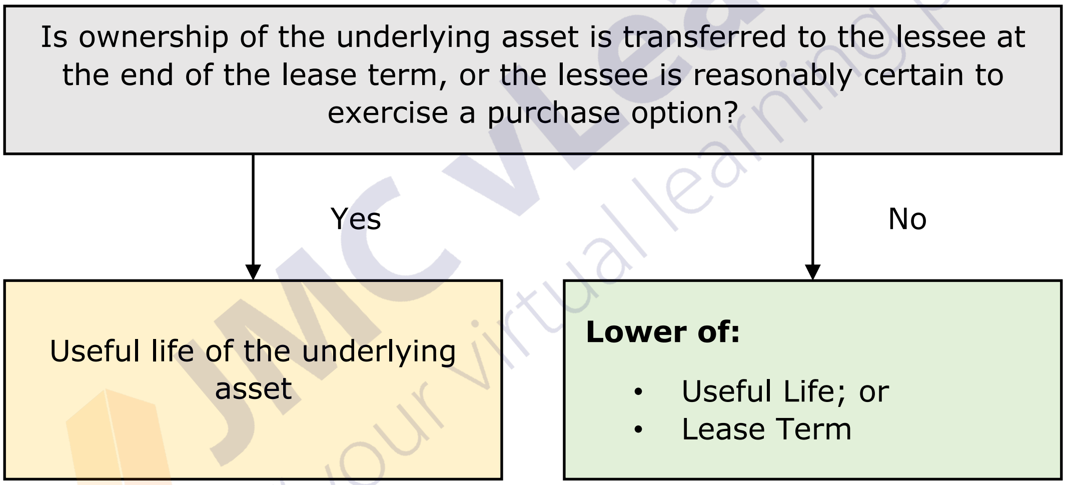
Applying Cost Model as per LKAS 16

Generally, a lessee measures right-of-use assets at cost less accumulated depreciation and accumulated impairment losses.

Initial measurement of ROUA	XXX
(-) Accumulated Depreciation	(XXX)
(-) Accumulated Impairment Loss	(XXX)
Carrying Amount (For SoFP)	**XXX**

A lessee shall depreciate the right-of-use assets in accordance with the requirements of LKAS 16 Property, Plant and Equipment. That means the depreciation method shall reflects the pattern in which the future economic benefits of the right-of-use asset are consumed. This will **usually result in a straight-line depreciation charge**.

Depreciation starts at the commencement date of the lease. The **period** over which the asset is depreciated **is determined** as follows.



A lessee applies LKAS 36 Impairment of Assets to determine whether a right-of-use asset is impaired and to account for any impairment. After recognition of an impairment loss, the future depreciation charges for the right-of-use asset are adjusted to reflect the revised carrying amount.

Question 14 – Subsequent Measurement – LL & ROUA (In arrears)

X Plc enters into a 5-year lease of a machine on 1 January Year 2022. Accordingly, X must pay an annual rental of Rs.100,000/- at the **end of each year**. Further, X has guaranteed the residual value of the asset as Rs.40,000 at the end of the lease term. X has incurred an initial direct cost of Rs.5,000. The implicit interest rate is 8%. The ownership will not get transferred to lessee at the end of the lease term. This machine has a useful life of 06 years.

Required:

1. Calculate the initial lease liability and the cost of ROUA and decide the accounting entries.
2. Calculate the total finance charge of the lease.
3. Prepare the lease liability amortization schedule over the lease term and write accounting entries for the first year. Further, identify the current and non-current portions of the lease liability at first year end.
4. Prepare a schedule reflecting how the ROUA is subsequently measured during the lease term.
5. Show how the final payment on residual value guarantee needs to be recorded.
6. What will be the entry if the asset has an actual value of Rs.35,000 at the end of the lease term.

Question 15 – Subsequent Measurement – LL & ROUA (In advance)

X Plc enters into a 5-year lease of a machine on 1 January Year 2022. Accordingly, X must pay an annual rental of Rs.100,000/- at the **beginning of each year**. X has incurred an initial direct cost of Rs.5,000. The implicit interest rate is 12.37%. The ownership will not get transferred to lessee at the end of the lease term. This machine has a useful life of 06 years.

Required:

1. Calculate the initial lease liability and the cost of ROUA and decide the accounting entries.
2. Calculate the total finance charge of the lease.
3. Prepare the lease liability amortization schedule over the lease term and write accounting entries for the first year. Further, identify the current and non-current portions of the lease liability at first year end.

2.5 PRESENTATION

A lessee presents leases in its financial statements as follows.

Statement of financial position	1. **Right-of-use asset** – Separate presentation in the statement of financial position* or disclosure in the notes to the financial statements

	2. **Lease liability** – Separate presentation in the statement of financial position or disclosure in the notes
Statement of profit or loss and other comprehensive income	• Interest expense on the lease liability need to be shown separately from the depreciation of ROUA in the finance cost.
Statement of cash flows	• **Operating activities** ○ Variable lease payments not included in the lease liability ○ Payments for short term and low-value leases (subject to use of recognition exemption) • **Financing activities** ○ Cash payments for principal portion of lease liability • **Depending on 'general' allocation** ○ Cash payments for the interest portion are classified in accordance with other interest paid

***Right-of-use assets that meet the definition of investment property are presented within investment property.**

2.6 DISCLOSURE

A lessee discloses information that provides a basis for users of financial statements to assess the effect that leases have on financial position, financial performance and cash flows. A lessee discloses information about leases for which it is a lessee in a single note or separate section in the financial statements.

However, a lessee does not need to duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

Quantitative Information
Relating to the statement of financial position • Additions to right-of-use assets • Year-end carrying amount of right-of-use assets by class of underlying asset and (if they are not presented separately) the corresponding line items in the statement of financial position • Lease liabilities and the corresponding line items in the statement of financial position if lease liabilities are not presented separately • Maturity analysis for lease liabilities

Relating to the statement of profit or loss and other comprehensive income (including amounts capitalized as part of the cost of another asset)

- Depreciation charge for right-of-use assets by class of underlying asset
- Interest expense on lease liabilities
- Expense relating to short-term leases for which the recognition exemption is applied (leases with a lease term of up to one month can be excluded)
- Expense relating to leases of low-value items for which the recognition exemption is applied
- Expense relating to variable lease payments not included in lease liabilities
- Income from sub-leasing right-of-use assets
- Gains or losses arising from sale-and-leaseback transactions

Relating to the statement of cash flows

- Total cash outflow for leases

Qualitative Information

- Description of how liquidity risk related to lease liabilities is managed
- Use of exemption for short-term and/or low-value item leases

Example: How to show a maturity analysis

The table below summarises the maturity profile of the Group's financial liabilities based on contractual undiscounted payments:

Year ended 31 December 2023	On demand	Less than 3 months	3 to 12 months	1 to 5 years	> 5 years	Total
	€000	€000	€000	€000	€000	€000
Interest-bearing loans and borrowings (excluding items below)	966	–	1,422	10,554	8,000	20,942
Lease liabilities (Note 31)	48	117	290	2,454	1,473	4,382
Convertible preference shares	–	–	–	676	2,324	3,000
Contingent consideration	–	–	1,125	–	–	1,125
Other financial liabilities	–	–	–	150	–	150
Trade and other payables	3,620	12,547	802	–	–	16,969
Derivatives and embedded derivatives	1,970	2,740	391	1,191	1,329	7,621
	6,604	**15,404**	**4,030**	**15,025**	**13,126**	**54,189**

2.7 REMEASUREMENT OF THE LEASE LIABILITY

After the commencement date, a lessee **remeasures the lease liability** to **reflect changes in the lease payments**. This occurs when;

- The lease term is revised
- There is a reassessment of the probability of a purchase option being exercised
- Variable lease payments (future lease payments based on an index or rate) are revised

- There is a change in the amount expected to be paid under residual value guarantees

When remeasuring the lease liability, a revised discount rate or the original rate can be used as follows.

Lessee shall remeasure the lease liability **using revised lease payments** and using a:

Revised Discount Rate

- Variable lease payments (future lease payments based on an index or rate) are revised
- There is a change in the amount expected to be paid under residual value guarantees

Original Discount Rate

- The lease term is revised
- There is a reassessment of the probability of a purchase option being exercised

Question 16 – Remeasurement – Variable Payments

On 1 January 2021, Kingfisher enters into a four year lease of property with annual lease payments of Rs.1 million, payable at the beginning of each year. According to the contract, lease payments will increase every year on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125.

The interest rate implicit in the lease is not readily determinable. Kingfisher's incremental borrowing rate is 5% per year. At the beginning of the second year of the lease the Consumer Price Index is 140.

Required: **Discuss** how the lease will be accounted for:

1. During the first year of the contract.
2. On the first day of the second year of the contract.

Question 17 – Remeasurement – Lease Term

X Plc enters into a 5 year lease of a machine on 1 January Year 1.The lease liability at the commencement of the lease was $426,494. X Plc incurred initial direct costs of $5,000 when arranging the lease. X Plc recognized a right of use asset at the commencement of the lease in the amount of $431,494 ($426,494 + $5,000).X Plc has guaranteed the residual value of the asset at the end of the lease term at $40,000.

Further information

- X Plc has an option to extend the lease term for a further three years at an annual rental of $110,000.
- At the commencement date, X Plc concluded that it was not reasonably certain to exercise the option, so the lease term was determined to be 5 years.
- X Plc would not have to guarantee a residual value if it were to exercise the option to extend the lease term.

End of Year 4

X plc's circumstances have changed, and it is now reasonably certain that it will exercise the option to extend the lease (meeting the conditions in IFRS 16). X Plc is unable to determine a revised interest rate implicit in the lease, but its incremental borrowing rate is 9%.

Required: **Discuss** how the lease will be accounted as per SLFRS 16.