"Pioneers in Professional Education"

CL 02 – Financial Reporting and Governance

Corporate Level

(SLFRS 16 – P2)

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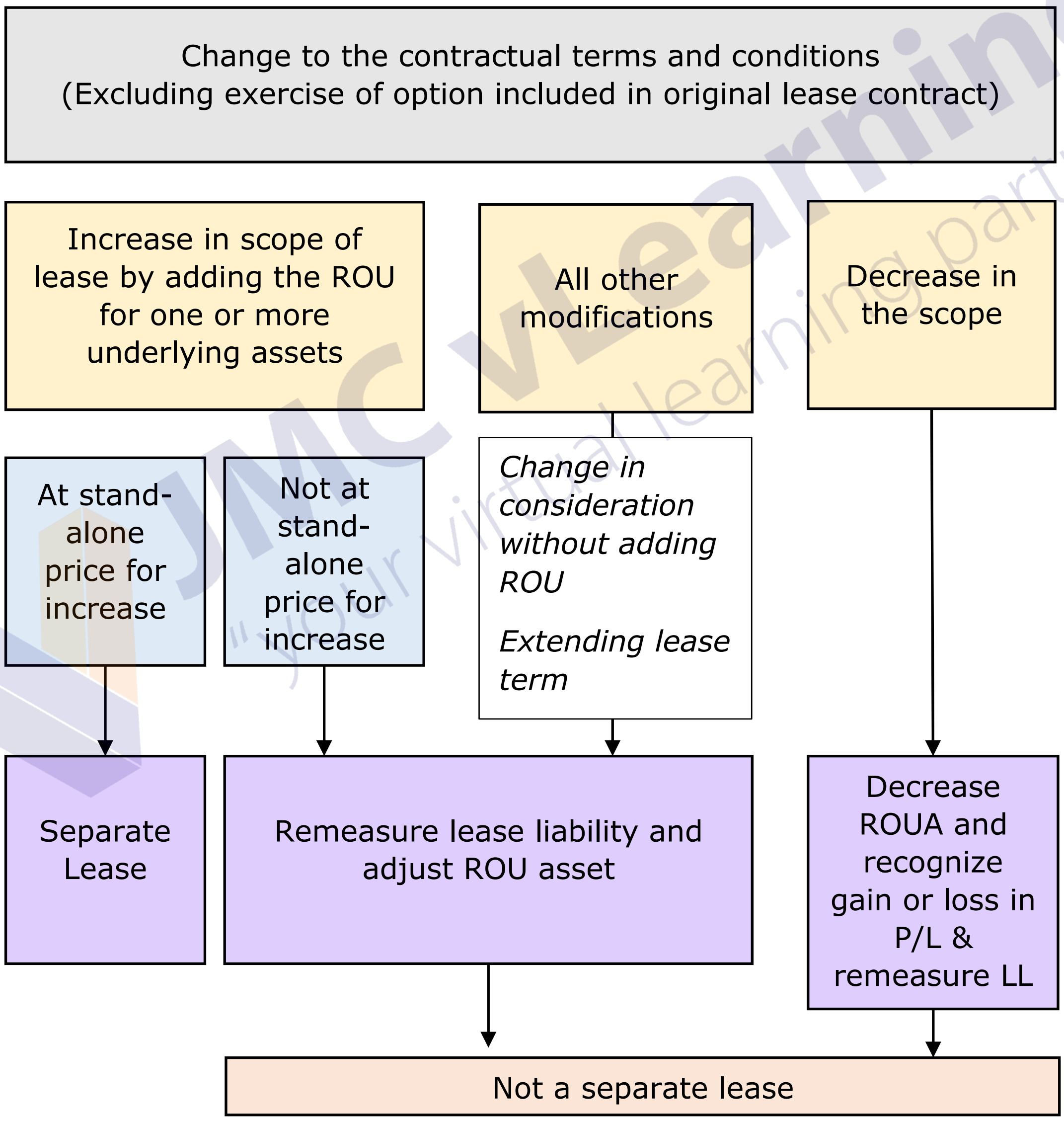
2.8 LEASES MODIFICATIONS

Lease modification is 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).

Following diagram summarizes the accounting requirement for lease modifications by a lessee ***(Para 44)***:



2.8.1 SEPARATE LEASE *(Para 44)*

A lessee accounts for a lease modification as a separate lease if both of the following conditions exist:

- the **modification increases the scope *(No of underlying assets or lease term)*** of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount commensurate with the Stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

In this case, the lessee accounts for the separate lease in the same way as any new lease and makes no adjustment to the accounting for the initial lease. The lessee uses a revised discount rate to account for the separate lease. The new rate is determined at the effective date of the modification. The lessee uses the interest rate implicit in the lease if it is readily determinable; otherwise, the lessee uses its incremental borrowing rate.

Question 18 – Lease Modifications

Identify whether below scenarios are lease modifications that result in a separate lease.

1. X Plc leases a building for an initial period of five years with an option to extend the lease for a further three years. 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. At the end of the fourth year of the lease 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).

2. Y Plc leases a building for five years. At the end of the fourth year of the lease X plc's circumstances have changed and it has contracted with the lessor to extend the lease for a further three years beyond the original lease term.

3. X Plc enters into a 6-year lease for 3 floors of an office block. At the end of Year 4, X Plc and the lessor agree to amend the original lease for the remaining 2 years to include an additional floor in the same block. The increase in the lease payments is commensurate with the current market rate for the extra floor as adjusted for a discount to reflect costs saved by the lessor in renting to X Plc. (For example, the lessor would save the marketing costs of finding new tenant).

2.8.2 NOT A SEPARATE LEASE

A lessee accounts for a lease modification that is not a separate lease, at the effective date of the modification by remeasuring the lease liability. The lessee allocates consideration in the modified contract, determines the lease term and remeasures the lease liability **at the effective date of the modification**.

To do so, the lessee discounts the revised lease payments using a revised discount rate determined at that date and:

- for lease modifications that decrease the scope of the lease, the lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and recognizes a gain or loss that reflects the **proportionate decrease in scope**.

- for all other lease modifications, the lessee makes a corresponding adjustment to the right-of-use asset.

Question 19 – Change in consideration (Not a separate lease)

On 1 April 2019, Sun acquired a warehouse on rent for a period of 5 years at an annual lease rental of Rs. 6 million, payable on 1 April of each year. Legal fees and stamp duty paid on the lease was 5% of the total lease rental value over the lease period. Per the agreement, the landlord paid 50% of the preliminary expenses.

However, on 1 April 2020 the agreement was amended by increasing the annual rental to Rs. 7 million for 2020/21 and 2021/22. Furthermore, an annual rental of Rs. 7.5 million will be charged for 2022/23 and 2023/24. The implicit interest rate of the lease as of 1 April 2019 and 1 April 2020 was 12% and 10%, respectively.

Required to **discuss** how to recognize this lease as per SLFRS 16?

Question 20 – Reduction in scope & consideration (Not a separate lease)

Lessee E entered into a 10-year lease for 10,000m^2 of office space with Lessor F. The rental payments are 100,000 per annum payable in arrears. The interest rate implicit in the lease cannot be readily determined and E uses its incremental borrowing rate. The incremental borrowing rate at commencement of the lease is 7%. There are no initial direct costs, lease incentives or costs to restore the leased asset to its original condition. Accordingly, E recorded a right-of-use asset and a lease liability of 702,358 at the commencement date.

At the beginning of Year 7, E and F agree to modify the lease by reducing the space to 7,500m^2 (i.e. a reduction of 2,500m^2) and the lease payments to 75,000 per annum, payable in arrears for the remaining four years. The incremental borrowing rate at this date is 8%, the pre-modification carrying amount of the right-of-use asset is 280,943 and the lease liability is 338,721.

Required to **explain** how this shall be accounted as per SLFRS 16?

Question 21 – Increase in lease term

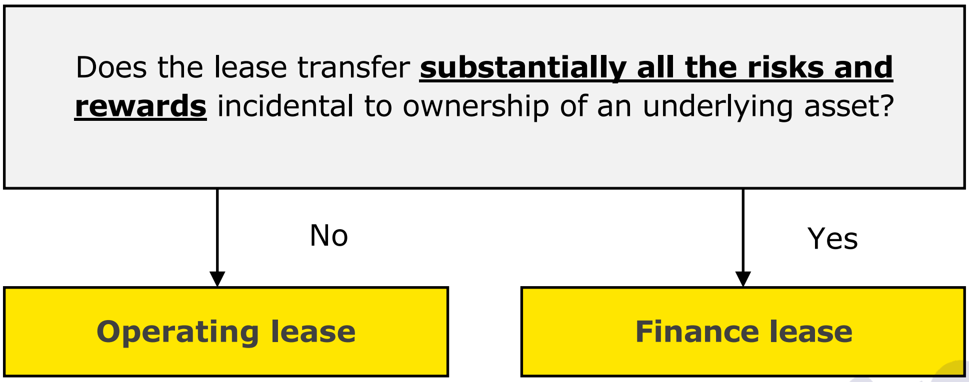
Lessee X enters into a 20-year lease of a manufacturing plant with Lessor Y. The annual lease payments are Rs. 150,000 payable in arrears. The incremental borrowing rate at commencement of the lease is 5%. Accordingly, X initially recognizes a lease liability and right-of-use asset of Rs. 1,869,332.

At the end of year 18 X and Y agree to modify the lease by extending the lease term for an additional 10 years. The annual lease payments remain unchanged and X's incremental borrowing rate at that date is 8%. The pre-modification carrying amount of the lease liability and right-of-use asset are Rs. 278,912 and Rs.186,933, respectively.

Required to **explain** how this shall be accounted as per SLFRS 16?

3. ACCOUNTING FOR LESSOR

lessor follows a dual accounting approach for lease accounting. The accounting is based on whether significant risks and rewards incidental to ownership of an underlying asset are transferred to the lessee**.**



Finance lease	A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset
Operating lease	A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset
Guaranteed residual value	For a lessor, that part of the residual value which 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.
Unguaranteed residual value	portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor
Gross investment in the lease	The sum of: (a) The lease payments receivable by the lessor under a finance lease, and (b) Any unguaranteed residual value accruing to the lessor.
Net investment in the lease	The gross investment in the lease discounted at the interest rate implicit in the lease
Unearned finance income	The difference between: (a) The gross investment in the lease and (b) The net investment in the lease

3.1 LEASE CLASSIFICATION

Generally, the presence of the following indicators, **either individually** or **in combination**, leads to a lease being classified as a finance lease: ***(Para 63)***

- Transfer of ownership to the lessee either during or at the end of the lease term
- Existence of a purchase option that is reasonably certain to be exercised
- The lease term is for a major part of the economic life of the underlying asset
- The present value of the lease payments amounts to substantially all of the fair value of the underlying asset at inception of the lease
- The underlying asset is specialized

Lease classification is made **at the inception date** and is **reassessed** only if there is a **lease modification**. Changes in estimates (e.g. changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (e.g. default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

Question 22 – Lease Classification

Lessor L enters into a non-cancellable lease contract with Company X under which X leases non-specialised equipment for five years. The economic life of the equipment is estimated to be 15 years and legal title will remain with L. The lease contract contains no purchase, renewal or early termination options. The fair value of the equipment is 100,000 and the present value of the lease payments amounts to 50,000.

Required to **assess** whether this is a finance lease or an operating lease as per SLFRS 16.

3.1.1 Leases of lands and buildings ***(Para B55)***

A **property** lease usually includes **both land and buildings**. Each element should be classified separately. In other words, a property lease is viewed as a lease of land and a different lease of the building.

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

Lease of the land

An important consideration is that **land normally has an indefinite economic life**. This means that the **lease term will not normally be for a major part of the life** of the asset and the asset will have a significant value at the end of the lease. This implies that the land element of the lease will usually be an operating lease.

This is not always the case. In some parts of the world a property lease might be very long (say 99 years). In a case like this, the unguaranteed residual value might be very large but in present value terms is negligible, leading the present value of the lease payments to be substantially all of the fair value of the asset at the inception of the lease. Such a lease could be a finance lease.

Lease of the building

The building is classified as a finance lease or as an operating lease according to the criteria to identify what type of a lease as mentioned above.

Splitting the payments when accounting

It is necessary to split the **total rental payments** for the land and building into the rental for the land and the rental for the **building based on the proportion of the relative fair values** of the leasehold interests in the land element and buildings element of the lease at the **inception of the lease**.

The relative fair value of the leasehold interests is from the point of view of the lessee. This means that the relative fair value of the leasehold interests is not the same as the relative fair value of the land and the building.

Example: Land and buildings

A company leases a property for Rs.450,000 per annum (in arrears). The lease is for 10 years and the useful life of the building is 8 years.

	Land (Rs.)	**Building (Rs.)**
Fair value	2,000,000	500,000
Fair value of leasehold interest	1,000,000	500,000

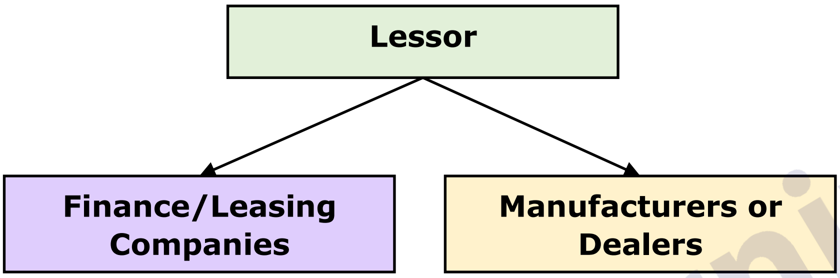
The rentals are allocated between the land and buildings in the ratio of Rs.1,000,000 to Rs.500,000 because it shall be the Fair value of leasehold interest not the fair value of the underlying asset.

	Rs.
Rental for land (2/3 * 450,000)	300,000
Rental for building (1/3 * 450,000)	150,000

If this cannot be done the entire lease must be 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.

If the land element is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification. In such a case, the economic life of the building is regarded as the economic life of the entire leased asset.

3.1.2 Types of lessors



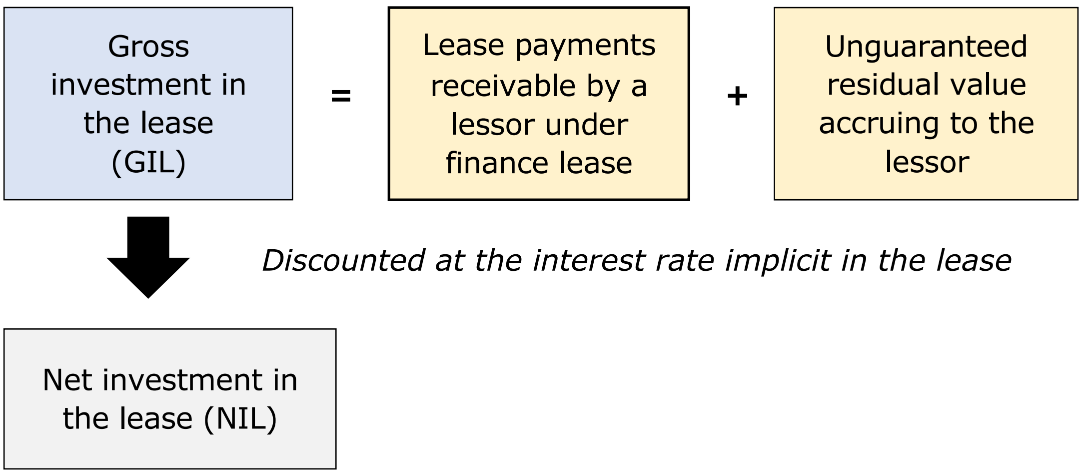
3.2 FINANCE LEASES - RECOGNITION *(Para 67)*

At **commencement date**, the **lessor derecognizes** the **underlying asset** and **recognizes a finance lease receivable** at an amount equal to its net investment in the lease, which comprises the present value of the lease payments and any unguaranteed residual value accruing to the lessor.

The present value is calculated by discounting the lease payments and any unguaranteed residual value, at the **interest rate implicit in the lease**. Initial direct costs are included in the measurement of the finance lease receivable, because the interest rate implicit in the lease takes initial direct costs incurred into consideration.

3.3 INITIAL MEASUREMENT

3.3.1 Initial measurement of net investment in the lease *(Para 26)*



Lease payments receivable by a lessor under finance lease includes:

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, initially measured using the index or rate as at the commencement date.
c) any residual value guarantees provided to the lessor by the lessee.
d) the exercise price of a purchase option if the lessee is reasonably certain to exercise.
e) payments of penalties for terminating the lease if the lease term reflects early termination.

Unguaranteed residual value accruing to the lessor:

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

3.3.2 Journal Entries for initial recognition

1. When the asset is purchased by the lessor from the seller

Dr	Asset	XXX
Cr	Cash	XXX

2. Recognizing the net investment in the lease

Dr	Net Investment in the lease (Finance lease receivable)	XXX
Cr	Asset	XXX

If there is any difference between the carrying amount of the underlying asset and the net investment in the lease which is recognized as finance lease receivable, it needs to be recognized as the **selling profit or loss**.

3. Recognizing the selling profit or loss (If any)

Dr	P/L (Selling loss)	XXX
Cr	Asset	XXX

Dr	Asset	XXX
Cr	P/L (Selling profit)	XXX

3.4 SUBSEQUENT MEASUREMENT

3.4.1 Subsequent measurement of finance lease receivable *(Para 75)*

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.

The finance lease receivable (net investment in the lease) is measured in the same way as any other financial asset at amortized cost as follows.

Finance lease receivable at the year beginning	XXX
+ Interest accrued	XXX
- Lease payments received during the year	(XXX)
Finance lease receivable at the year end	**XXX**

It is important to note that finance companies do not present their statement of financial position separating assets as current and non-current. Therefore, for a lessor who is a finance company no need to split the year end lease receivable as current and non-current.

3.4.2 Journal Entries for initial recognition

1. Accruing the interest

Dr	Finance lease receivable	XXX
Cr	Finance Income (P/L)	XXX

2. Receipt of the lease payments

Dr	Cash	XXX
Cr	Finance lease receivable	XXX

Total Finance Income

	Rs.
Gross investment in the lease	XXX
Net investment in the lease	(XXX)
Total finance income	**XXX**

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

Question 23 – Finance Income

X Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1. The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of $18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was $80,000 and Ready Finance incurred initial direct costs of $2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is $10,000. The lessee has guaranteed an amount of $8,000. The interest rate implicit in the lease is 10.798%.

Required:

1. Calculate the total finance income.

Question 24 – Lessor Accounting

Ready Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1. The lease was a 6-year finance lease of a machine on 1 January Year 1 with annual lease payments of $18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was $80,000 and Ready Finance Plc incurred initial direct costs of $2,000 when arranging the lease. The estimated residual value of the asset at the end of the lease is $ 10,000 and the lessee has guaranteed $8,000 of this amount.

The interest rate implicit in the lease is 10.798%.

Required:

Explain with calculations on how to account this under SLFRS 16.

Question 25 – Lessor Accounting

Mandil Plant Company leased an asset to another company with effect from 1 January 2018. The terms of the lease were as follows:

- Lease term of eight years
- Rentals of Rs. 1,540,000 per annum are payable in advance
- The interest rate implicit in the lease is 12.8%

The fair value of the asset on 1 January 2018 was Rs. 8,330,000 and legal fees associated with the lease amounting to Rs. 70,000 were payable by the Mandil

Plant Co on this date.

Required:

What amounts are recognized in Mandil Plant Co's financial statements for the year ended 31 December 2018 in respect of the lease?

3.5 MANUFACTURER OR DEALER LEASES *(Para 71)*

Manufacturers or dealers often offer to 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:

1. **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
2. **finance income** over the lease term.

When a manufacturer or dealer accounts for such a lease at the commencement date the lessor shall recognize the following or each of its finance leases.

1. **Revenue** – The **lower** of the fair value of the underlying asset and the present value of the lease payments accruing to the lessor, discounted using a **market rate of interest***.
2. **Cost of Sales** – The carrying amount of the underlying asset less the present value of unguaranteed residual value.
   - *The deduction of the present value of the unguaranteed residual value recognizes that this part of the asset is not being sold. This amount is transferred to the lease receivable. The balance on the lease receivable is then the present value of the amounts which the lessor will collect off the lessee plus the present value of the unguaranteed residual value. This is the net investment in the lease as defined earlier.*
3. **Profit from sales** - The **difference** between the sales revenue and the cost of sale is the selling profit or loss.
   - *This need to be recognized in accordance with its policy for outright sales to which SLFRS 15 applies. A manufacturer or dealer lessor shall recognize selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in SLFRS 15.*

*The manufacturer or dealer might offer **artificially low rates of interest** on the finance transaction. In such cases the selling profit is restricted to that which would apply **if a market rate of interest were charged**.

It is important to note that the Initial Direct Costs (Transactions Costs) for a manufacturer or dealer lease shall be charged to P/L.

Question 26 – Lessor Accounting – Manufacturer or Dealer Leases

The following information is relevant:

- Price of the car in a cash sale - $2,000,000
- Cost of the car - $1,500,000

Financing options:

- Annual rental - $764,018
- Lease term - 3 years
- Interest rate - 10%
- Estimated residual value - $133,100
- Lessor's cost of setting up the lease - $20,000

Required:

Explain with calculations on how to account this under SLFRS 16?

3.6 OPERATING LEASES ACCOUNTING *(Para 81)*

The lessor classifies a lease that is not a finance lease as an operating lease applying para 63.

If, before lease commencement, a lessor recognizes an asset in its statement of financial position and leases that asset to a lessee under an operating lease, then the lessor **does not derecognize the asset** on lease commencement. Generally, future contractual rental payments from the lessee are recognized as receivables over the lease term as the payments become receivable.

A lessor shall recognize 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 from the use of the underlying asset is diminished.

Similarly, increases (or decreases) in rental payments over a period of time, other than variable lease payments, are reflected in the determination of the lease income, which is recognized on a straight-line basis.

3.6.1 Accounting for initial direct costs *(Para 83)*

The **initial direct costs incurred** by the lessor in arranging an operating lease are **added to the carrying amount of the underlying asset and cannot be recognized immediately as an expense**. These initial direct costs are recognized as an expense on the same basis as the lease income. This will not necessarily be consistent with the basis on which the underlying asset is depreciated.

3.6.2 Accounting for lease incentives

Incentives granted to the lessee in negotiating a new or renewed operating lease are **recognized as an integral part of the lease payments** relating to the use of the underlying asset. They are **recognized as a reduction of rental income over the lease term** using the same recognition basis as for the lease income.

This can include:

- Up front cash payments at reduced amounts
- Rent free periods

3.6.3 Depreciation of the underlying asset

The lessor depreciates the underlying asset over the asset's useful life in a manner that is consistent with the depreciation policy that it applies to similar owned assets.

Question 27 – Lessor Accounting – Operating Leases

Hippala Leasing PLC leases office equipment to a number of companies in Colombo. On 1 January 2015 it entered into a lease agreement with another company for the supply of three photocopiers for three years, at a total cost of Rs. 150,000 per annum payable in arrears. The costs of negotiating the lease amounted to Rs. 21,000. The photocopiers were purchased by Hippala on 1 January 2015 at a cost of Rs. 200,000 each and they have an estimated useful life of five years.

Required

Record the amounts Hippala should recognize in profit and loss in the year ended 31 December 2015 in respect of the leased assets.

Question 28 – Lessor Accounting – Lease Incentives

X Limited signed a contract to lease an asset to a customer on 1 January 2016. The lease was for 20 years. The first year is rent free with rentals of $30,000 per annum payable in arrears thereafter.

Required: Explain with calculations on how to account this under SLFRS 16?

3.7 PRESENTATION

A lessor presents leases in its financial statements as follows.

Finance Lease	Operating Lease
Statement of financial position	
Present assets held under a finance lease as a receivable at an amount equal to the net investment in the lease	Present the underlying assets subject to operating leases according to the nature of the underlying asset

3.8 DISCLOSURE

Normally, a lessor discloses at least the following information.

Finance Lease	Operating Lease
Quantitative Information	
– Selling profit or loss – Finance income on the net investment in the lease – Lease income relating to variable lease payments not included in the net investment in the lease	– Lease income relating to variable lease payments that do not depend on an index or rate – Other lease income – Detailed maturity analysis of the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years
– Significant changes in the carrying amount of the net investment in the lease – Detailed maturity analysis of the lease payments receivable – A reconciliation between the undiscounted lease payments and the net investment in the lease, identifying the unearned finance income and any discounted unguaranteed residual value	– If applicable, disclosures in – accordance with LKAS 16 separately from other assets), LKAS 36, LKAS 38 Intangible Assets, LKAS 40 and LKAS 41 Agriculture
Qualitative Information	
– Significant changes in the carrying amount of the net investment in the lease	– N/A