SLFRS 16: Leases

Introduction

This Standard 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. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cashflows of an entity. In this context, this chapter discusses the accounting treatment for leases according to IFRS 16 Leases by the lessee.

Identifying a Lease

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A lease is a contract that conveys the right to use an identified asset for a period of time in exchange for consideration. Therefore, a lease is an agreement between two parties (lessee and lessor) to hire an asset. The lessor is the legal owner of the asset who rents out the asset to the lessee, who acquires the asset. The lessee will pay a lease rental to the lessor in return for the use of the asset.

Accounting for Leases in the Books of Lessee

A lessee may elect not to apply the requirements in SLFRS 16 for

(a) *short-term leases*; and
(b) leases for which the *underlying asset* is of low value

Short-term lease is a **lease** that, at the commencement date, has a lease term of 12 months or less.

If a lessee elects not to apply the requirements in SLFRS 16 to either short-term leases or leases for which the underlying asset is of low value, the lessee shall recognize the *lease payments* associated with those leases 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.

In substance, where a lessee enters a lease arrangement, it is essentially the same as acquiring the asset by way of a long term-loan.

The accounting treatment of a lease is discussed below at both initial recognition and measurement subsequent to recognition.

(a) Initial Recognition

At the commencement date, a lessee should recognize a right-of-use asset and a lease liability. Right-of-use asset is an asset that represents a lessee's right to use an underlying asset for the lease term.

(b) Measurement

i. **Initial Measurement of the Right-of-use Asset**
At the commencement date, a lessee shall measure the right-of-use asset **at cost.** The cost of the right-of-use asset is comprised:

(a) the amount of the initial measurement of the lease liability (**present value of the lease payments**)
(b) any lease payments made at or before the commencement date, less any *lease incentives* received (**E.g., Initial payment/ Down payment**)

(c) any *initial direct costs* incurred by the lessee (**E.g., Legal fees incurred by the lessee**)

(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.

Please note that only (a) and (b) are typically considered in the A/L.

ii. **Initial Measurement of the 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:

(a) *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 if the lessee is reasonably certain to exercise that option
(e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Please note that only fixed lease payments are considered in the A/L.

Example 1:
ABC PLC acquired a machine on a lease basis on 01.04.20X4. The following information is provided.

- Initial payment on 01.04.20X4 was Rs.800,000
- The lease term is 4 years.
- Installations: annual installments Rs. 200,000 each to be paid at the end of each year starting from 31.03.20X5.
- The interest rate implicit in the lease is 10% and the discount factor for each year at this rate is follows:

Year	**1**	**2**	**3**	**4**
Discount factor	0.909	0.826	0.751	0.683

Initial measurement of lease liability is as follows:

	Lease payments	**Discount factor**	**Present value**
1	200,000	0.909	181,800
2	200,000	0.826	165,200
3	200,000	0.751	150,200
4	200,000	0.683	136,600
			633,800

The cost of use machine as at 01.04.20X4 is as follows:

Initial payment	800,000
Initial measurement of the lease liability	633,800
	1,433,800

iii. Subsequent Measurement of the Right-of-use Asset

After the commencement date, a lessee shall measure the right-of-use asset applying a cost model. However, If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in LKAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

For example, if machinery categorized as PPE is measured using the revaluation model for subsequent measurement, the right-of-use machine may also be measured using the revaluation model for subsequent measurement.

Cost Model

To apply a cost model, a lessee should measure the right-of-use asset at cost. Here, the carrying amount of right of use asset is as follows:

Carrying amount = Cost - Accumulated depreciation

Depreciation of a Leased Asset

A lessee shall apply the depreciation requirements in LKAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset, subject to the following requirements.

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, the lessee should depreciate the right-of-use asset from the commencement date to the end of the ***useful life*** of the underlying asset.

Example 2:

Assume the following additional information is also provided with respect to Example 1.

- The ownership of the machine is transferred to the lessee by the lessor at the end of the lease term.
- Useful life: 8 years
- Residual value: Rs. 233,800

The depreciation charge for a year can be calculated as follows:

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Useful life}}$$

$$= \frac{1{,}433{,}800 - 233{,}800}{8}$$

$$= 150{,}000$$

If the lease does not transfer ownership of the underlying asset to the lessee by the end of the lease term, the lessee should depreciate the right-of-use asset from the commencement date to the earlier of the end of the *useful life* of the right-of-use asset or the end of the lease term.

Example 3:

Assume the following additional information is also provided with respect to Example 1.

- The ownership of the machine is not transferred to the lessee by the lessor at the end of the lease term.
- Useful life: 8 years
- Residual value: Nil

The depreciation charge for a year can be calculated as follows:

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Lower of useful life and lease term}}$$

$$= \frac{1,433,800 - 0}{4}$$

$$= 358,450$$

iv. Subsequent Measurement of the 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 *and*

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

The interest on the lease liability in each period during the lease term can be calculated as follows:

Lease interest = Remaining balance of the lease liability at the beginning of the period X implicit lease interest rate

After the commencement date, a lessee should recognize interest in the lease liability in profit or loss as an expense.

Example 4:

With reference to Example 1, the lease liability account for the first year can be prepared as follows:

Lease Liability

31.03.20X5	200,000	01.04.20X4	633,800	
		31.03.20X5	63,380	(633,800x10%)
31.03.20X5	497,180			
	697,180		697,180	
		01.04.20X5	497,180	

Presentation

The recommended presentation for leases in relation to A/L is as follows:

In the statement of financial position, a lessee shall present:

(a) Right-of-use assets separately from other assets.

(b) Lease liabilities separately from other liabilities.

In the statement of profit or loss, a lessee shall present:

(a) Lease interest as a finance cost

In the statement of cash flows, a lessee shall classify:

(a) Cash payments for the principal portion of the lease liability within financing activities
(b) Cash payments for the interest portion of the lease liability applying the requirements in LKAS 7: Statement of Cash Flows for interest paid (usually within operating activities)
(c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Example: 5

The presentation for the first year of the lease transaction in Example 1 is as follows: It is assumed that ownership of the machine is transferred to the lessee by the lessor at the end of the lease term. Additionally, it is assumed that the useful life and residual value of the right-of-use machine are 8 years and Rs. 233,800, respectively.

The statement of profit or loss
For the year ended 31.03.20X5

Administrative expenses

Right of use machine depreciation 150,000

Finance cost

Lease interest 63,380

Statement of financial position
As at 31.03.20X5

Non-current assets

Right of use asset (Note 1) 1,283,800

Non-current liabilities

Lease liability 346,898

Current liabilities

Lease liability	150,282

Note 1: Right of use asset

Cost	1,433,800
Less: Accumulated depreciation	(150,000)
Carrying amount	**1,283,800**

Workings:

	Current liability
Second year payment	200,000
Second year interest	(49,718)
	150,282

	Non-current liability
Total liability	497,180
Less: current liability	(150,282)
	346,898

Disclosure

A few disclosures that should be made by a lessee are as follows:

- depreciation charge for right-of-use assets by class of the underlying assets
- interest expense on lease liabilities
- the expense relating to variable lease payments not included in the measurement of lease liabilities
- total cash outflow for leases
- the carrying amount of right-of-use assets at the end of the reporting period by class of underlying assets