IFRS 16- LEASES

Lease. A contract or part of a contract that conveys the right to use an asset for a period of time in exchange for consideration. This is a contract between two parties where one party known as lessor (owner) gives another party known as lessee the right to use the asset and enjoy the benefits and risk associated with the utilization of the asset.

In order for such a contract to exist the user of the asset needs to have the right to:

- **Obtain substantially all of the economic benefits from the use of the asset.**
- **The right to direct the use of the asset**.

IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

a) The customer has the right to direct how and for what purpose the asset is used throughout its period of use; or

b) The relevant decisions about use are pre-determined and the customer has the right to operate the asset throughout the period of use without the supplier having the right to change these operating instructions.

DEFINITION OF TERM

1) **Finance lease.** A lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.
2) **Operating lease.** A lease other than a finance lease.
3) **Lease term.**
4) **Unguaranteed residual value**. That portion of the residual value of the underlying asset, the realization of which by the lessor is not assured.

Types of leases.

(a) Operating lease.
(b) Finance lease.
(c) Sell and leaseback lease.
(d) Leverage lease

Operating lease/off balance sheet lease.

This is a short term lease.it has the following characteristics:

- The lease period is very short relative to the economic life of the asset.
- The lease contract can be cancelled by either party any time before end of lease period.
- The owner (lessor) incurs maintenance, operating and insurance expenses of the asset.
- The lessee is not given an option to buy the asset at the end of lease period.

Finance lease/capital lease.

This is long-term in nature and the lease period is almost equal to the economic life of the asset.

Characteristics.

- The lease period should be at least equal to 75% of the asset economic life.
- The lease contract cannot be cancelled by either party before lease period matures.
- The lessee incurs all maintenance cost.
- The lessee is given an option to buy the asset at the end of lease period.

Advantages of a lease.

1. Lease does not involve strict terms and conditions associated with long term debts.
2. Leasing has lower effective cost compared to long term debts.

3. It does not require a significant initial capital investment compared with cost of buying new asset.
4. It reduces the risk of obsolescence.
5. It provides off-balance sheet financing i.e. operating lease are shown as foot notes to the financial statements.

Differences between finance and operating lease.

Finance lease	Operating lease
1. It is a long term lease taking more than 75% of economic life of the asset.	It is a short term lease.
2. The lessee has an option to purchase the asset at the end of the lease period.	The lessee has no such option.
3. The contract cannot be cancelled before maturity.	The lease contract can be canceled any time before maturity.
4. The lessee incurs all incidental operating expenses and account for the items in its financial statement	The lessor incurs the operating expenses and accounts for the asset in his books of account.

ACCOUNTING FOR LEASES BY LESSEE

Accounting treatment

Initial recognition

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessee recognizes:

1) **A lease liability**
2) **A right-of-use asset**

Lease liability

The lease liability is initially measured at the **present value of lease payments not paid at the commencement date**, discounted at the **interest rate implicit in the lease** (or the lessee's incremental borrowing rate **if the interest rate implicit in the lease** if not readily determinable).

The lease liability cash flows to be discounted include the following

1) Fixed payments
2) Variable payments that depend on an index (e.g. CPI) or rate (e.g. market rent)
3) Amounts expected to be payable under residual value guarantees (e.g. where a lessee guarantees to the lessor that an asset will be worth a specified amount at the end of the lease)
4) Purchase options (if reasonably certain to be exercised).

Right-of-use asset

The right-of-use asset is initially measured at it's, which includes:

1) The amount of the **initial** measurement of the lease liability (the present value of lease payments **not** paid at the commencement date)
2) Payments made at/before the lease commencement date (less any lease incentives received)
3) Initial direct costs (e.g. legal costs) incurred by the lessee
4) An estimate of dismantling and restoration costs (where an obligation exists).

The right-of-use asset is normally measured subsequently at **cost less accumulated depreciation and impairment losses** in accordance with the cost model of **IAS 16 PPE.**

*The right-of-use asset is **depreciated** from the commencement date to the **earlier of** the **end of its useful life** or **end of the lease term** (end of its useful life if ownership is expected to be transferred).*

Alternatively the right-of-use asset is accounted for in accordance with:

a) The **revaluation model of IAS 16 (optional** where the right-of-use asset relates to a class of property, plant and equipment measured under the revaluation model, and where elected, must apply to all right-of-use assets relating to that class).

b) The **fair value model of IAS 40 *Investment Property*** (**compulsory** if the right-of-use asset meets the definition of investment property and the lessee uses the fair value model for its investment property).

Right-of-use assets are presented either as a separate line item in the statement of financial position *or* by disclosing which line items include right-of-use assets.

Lessor accounting

Classification of leases for lessor accounting

The approach to lessor accounting classifies leases into two types:

1) Finance leases (where a lease receivable is recognized in the statement of financial position); and

2) Operating leases (which are accounted for as rental income).

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.

Finance leases

Recognition and measurement

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessor derecognizes the underlying asset and recognizes a receivable at an amount equal to the **net investment in the lease**.

The **net investment in the lease** is the sum of:

Present value of lease payments receivable by the lessor	**xx**
Present value of any unguaranteed residual value accruing to the lessor	xx
	xx

The **unguaranteed residual value** is 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.

Essentially, an unguaranteed residual value arises where a lessor expects to be able to sell an asset at the end of the lease term for more than any minimum amount guaranteed by the lessee in the lease contract.

Amounts guaranteed by the lessee are included in the 'present value of lease payments receivable by the lessor' as they will always be received, so only the unguaranteed amount needs to be added on, which accrues to the lessor because it owns the underlying asset.

Finance income is recognized 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 **de recognition** and **impairment** requirements of IFRS 9 *Financial Instruments* are applied to the net investment in the lease.

Illustration 5

A lessor enters into a 3 year leasing arrangement commencing on 1 January 2013. Under the terms of the lease, the lessee commits to pay Sh.80,000 per annum commencing on 31 December 2013.

A residual guarantee clause requires the lessee to pay Sh.40,000 (or Sh.40,000 less the asset's residual value, if lower) at the end of the lease term if the lessor is unable to sell the asset for more than Sh.40,000.

The lessor expects to sell the asset based on current expectations for Sh.50,000 at the end of the lease. The interest rate implicit in the lease is 9.2%. The present value of lease payments receivable by the lessor discounted at this rate is Sh.232,502.

Required

Show the net investment in the lease from 1 January 2013 to 31 December 2015 and explain what happens to the residual value guarantee on 31 December 2015.

Solution

The net investment in the lease (lease receivable) on 1 January 2013 is:

	Sh.
Present value of lease payments receivable by the lessor	232,502
Present value of unguaranteed residual value (50,000 – 40,000 = 10,000 × 1/1.092^3)	7,679
	240,181

The net investment in the lease (lease receivable) is as follows:

	2013 Sh.	2014 Sh.	2015 Sh.
1 January b/d	240,181	182,278	119,048
Interest at 9.2% (interest income in P/L)	22,097	16,770	10,952
Lease installments	(80,000)	(80,000)	(80,000)
31 December c/d	182,278	119,048	50,000

On 31 December 2015, the remaining Sh.50,000 will be realized by selling the asset for Sh.50,000 or above, or selling it for less than Sh.50,000 and claiming up to Sh.40,000 from the lessee under the residual value guarantee.

Illustration:

MAY 2018 Q46

Disposal gain $40{,}000{,}000 - 14000{,}000 = 26{,}000{,}000$

- Initial lease liability = fair value = 40,000,000

OR

$= 15521200 \times PVIFA^{3}_{8\%}$

$15521200 \times \frac{1-(1+0.08)^{-3}}{0.08}$

$15521200 \times 2.5771 = 40{,}000{,}000$

Amortization schedule @ 8%

period	Balance bfd	interest	payment	principle	Bal c/d.
2016	40,000,000	3200,000	15521200	12321200	27678800
2017	27678800	2214304	15521200	13306896	14371904
2018	14371904	1149752	1521200	14371904	0

Income statement extract

	2016	2017	2018
Income			
Disposal gain.	26000,000	0	0
Expenses			
Interest	3200,000	2214304	1149752
Depreciation. (40÷3)	13333,000	13333333	13333,333

Statement of financial position.

	2016	2017	2018
Non-current Asset			
Right to use asset (NBV) 40,000,000 - 13333333	26666 667	13333,333	0
Non-current liabilities			
lease obligation.	14371904	—	—
current liabilities			
lease obligation.	13306896	14371904	—

AUG 2022 Q4a

(a) **Lease contract (IFRS 16)**

~~Inception of the~~ Lease on -1

W1 **Initial Lease liability**

$500{,}000 \times PVIFA^{3}_{10\%}$

$500{,}000 \times \frac{1-(1+0.1)^{-3}}{0.1} = 1243.425$

W2 **Initial right to use asset**

lease liability	1243 425
add: Initial direct cost	30,000
Add: payment in advance	0
Initial right to use asset	1273,425

Amortization schedule

period	opening Balance	interest cost 10%	payment	principle	Bal c/d.
2019	1243425	124343	500,000	375657	867768
2020	867768	86,777	500,000	413223	454545
2021	454545	45455	500,000	454545	0

Inception of lease on 1 January 2019

Dr: Right of use asset	1273 425	
Cr: Cash at bank		30,000
Cr: lease liability		1243425

Brakewood ltd

Income statement extract for the year ended 31 Dec

	2019	2020	2021
Expenses	sh	sh	sh
Depreciation (1273425 ÷ 3)	424475	424,475	424,475
Finance cost	124343	86777	45455

Brakewood ltd

statement of financial position extract as at 31 Dec

	2019	2020	2021
Non-current Asset	sh	sh	sh.
Right to use asset	1273425	1273425	1273425
less: depreciation.	(424475)	(848950)	(1273425)
Carrying amount	848950	424475	0
Non-current liability			
lease obligation	454545	0	0
Current liability			
lease liability.	413223	454545	0

Handout Q1 P1 (Illustration)

Payment in Advance

Question:

A company enters into a 4-year lease commencing 1 Jan 2019 (and intends to use the asset for 4 years). The terms are 4 payment of sh 50,000, commencing on 1 Jan 2019, and annually thereafter. The interest rate implicit in the lease is 7.5% and the present value of lease payments not paid at 1 Jan 2019 (i.e 3 payment of sh 50,000) discounted at that rate is sh 130,026.
Legal cost to set up lease incurred by the company were sh 402.

Required:
Show the lease liability from 1 Jan 2019 to 31 Dec 2022 and explain the treatment of the right to use asset.

Solution:

Amortization schedule

period	Balance bfd	payment	Balance due	7.5% interest	Bal cfd
2019	130026	(0)	130026	9752	139778
2020	139778	(50,000)	89778	6733	96551
2021	96551	(50,000)	46551	3488	50039
2022	50039	(50,000)	0	0	0

Right to use asset is recognized (at lease commencement date) 1 Jan 2019. at

Payment	
present value of lease payment not paid (lease liability)	130026
add: payment made at the commencement	50,000
add: initial direct cost	402
	180428

This amount will be depreciated over 4 years

Income statement extract

	2019	2020	2021	2022
interest expense	9752	6733	3488	0
Dep 180428 ÷ 4	45107	45107	45107	45107

Statement of financial position extract

	2019	2020	2021	2022
Assets				
Non-current assets				
Right to use asset (180428 − 45107)	135321	90214	45107	0
Non-current liabilities				
lease obligation	89778	46551	0	0
Current liabilities				
lease obligation	50000	50000	50000	0

NOV 2016 Q2 Note 3

lease liability

$$132 \times PVIFA^{4}_{10\%} \Rightarrow 132 \times \frac{1-(1+0.1)^{-4}}{0.1}$$

$$132 \times 3.1699 = 418M$$

Right to use asset

lease obligation: 418M
add: payment in advance: 132
550

$$Dep = 550 \div 5 = 110M$$

lease Amortization schedule

Period	Balance bfd	payment	Bal due	interest	Bal cfd
1	418	(0)	418	41.8	459.8
2	459.8	(132)	327.8	32.8	360.6
3	360.6	(132)	228.6	22.9	251.5
4	251.5	(132)	119.5	12	131.5
5	131.5	(132)	0	0	0