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SLFRS 16
Leases

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Reading for MBA (PIM), CA and CIMA Prize Winner

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Accounting Standards

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SLFRS 16 - Leases

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This is Vihanga

Vihanga wants a car

Car is worth of Rs. 5,000,000/-

But Vihanga has only Rs. 1,200,000/- in hand

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Vihanga has 3 options

- Using Savings: Buying the car using savings will take a long time
- By obtaining a Loan: Bank loans take time, not as long as savings. But more hassles such as finding guarantors, providing documents etc.
- By Leasing: Obtaining through a lease is faster and need lesser documents

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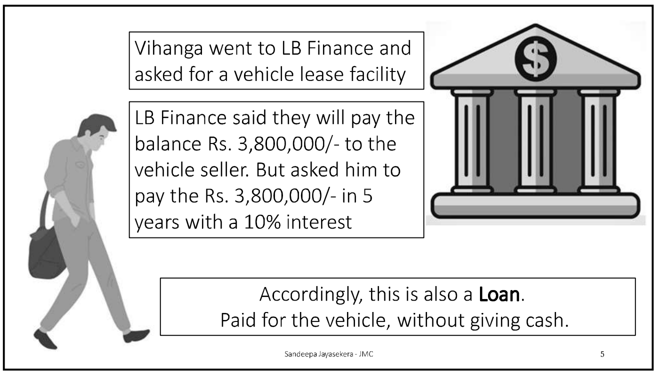
Vihanga went to LB Finance and asked for a vehicle lease facility
LB Finance said they will pay the balance Rs. 3,800,000/- to the vehicle seller. But asked him to pay the Rs. 3,800,000/- in 5 years with a 10% interest
Accordingly, this is also a **Loan**.
Paid for the vehicle, without giving cash.
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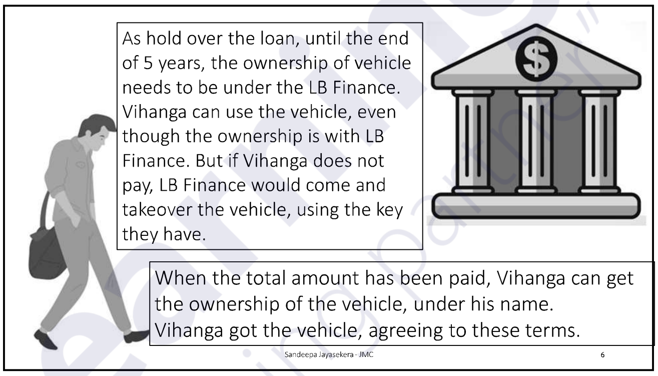
As hold over the loan, until the end of 5 years, the ownership of vehicle needs to be under the LB Finance. Vihanga can use the vehicle, even though the ownership is with LB Finance. But if Vihanga does not pay, LB Finance would come and takeover the vehicle, using the key they have.
When the total amount has been paid, Vihanga can get the ownership of the vehicle, under his name.
Vihanga got the vehicle, agreeing to these terms.
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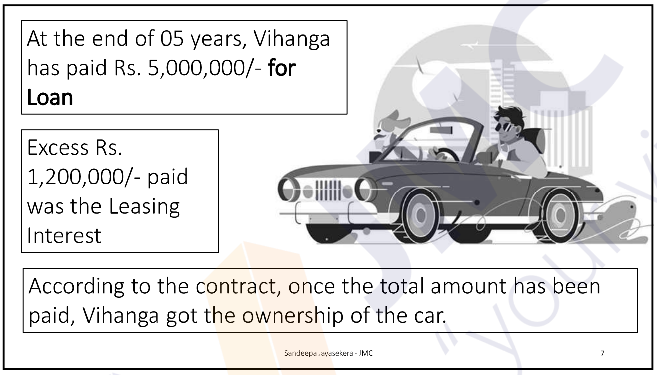
At the end of 05 years, Vihanga has paid Rs. 5,000,000/- **for Loan**
Excess Rs. 1,200,000/- paid was the Leasing Interest
According to the contract, once the total amount has been paid, Vihanga got the ownership of the car.
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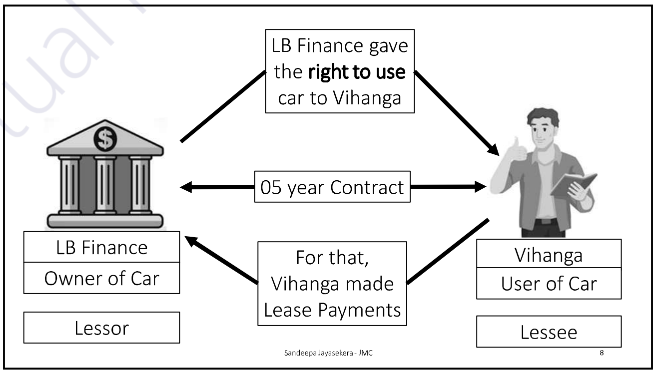
LB Finance gave the **right to use** car to Vihanga
05 year Contract
For that, Vihanga made Lease Payments
LB Finance
Owner of Car
Lessor
Vihanga
User of Car
Lessee
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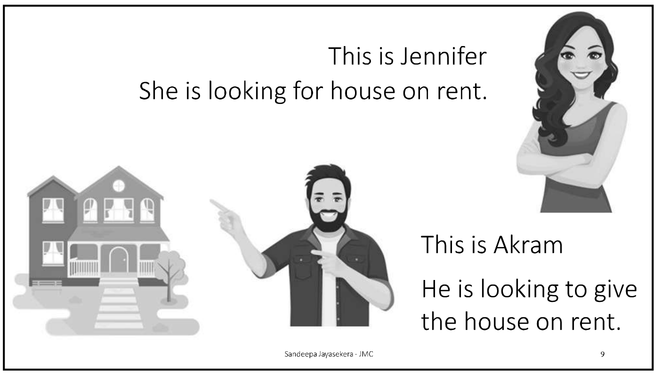
This is Jennifer
She is looking for house on rent.
This is Akram
He is looking to give the house on rent.
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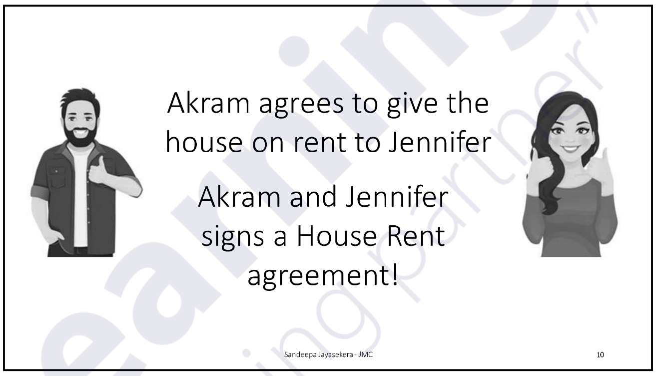
Akram agrees to give the house on rent to Jennifer
Akram and Jennifer signs a House Rent agreement!
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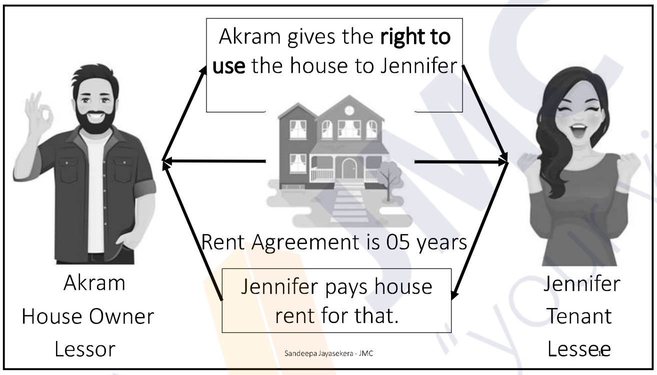
Akram gives the **right to use** the house to Jennifer
Rent Agreement is 05 years
Jennifer pays house rent for that.
Akram
House Owner
Lessor
Jennifer
Tenant
Lessee
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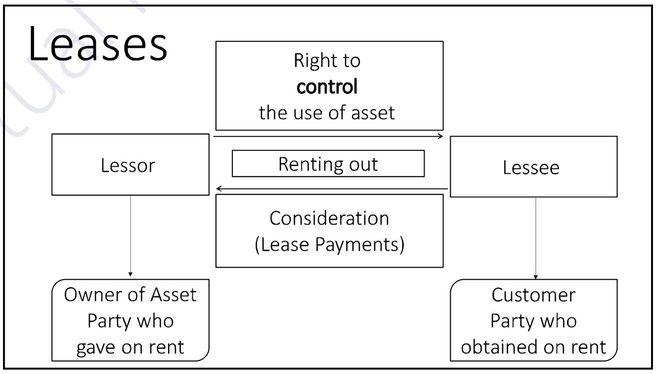
Leases
Right to
control
the use of asset
Lessor
Renting out
Lessee
Consideration
(Lease Payments)
Owner of Asset
Party who
gave on rent
Customer
Party who
obtained on rent

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Accounting in Lessee’s Books

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Accounting for Leases
Step 01
Determining whether a Contract contains a Lease

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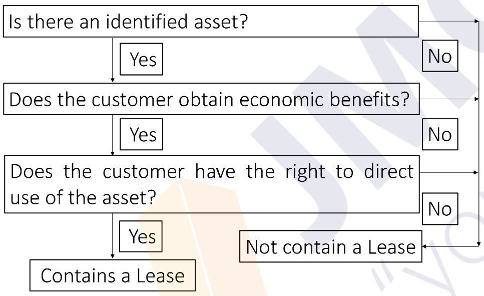
Determining whether a Contract contains a Lease



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Accounting for Leases
Step 02
Exemptions -
Instances that can be excluded from Accounting for Leases

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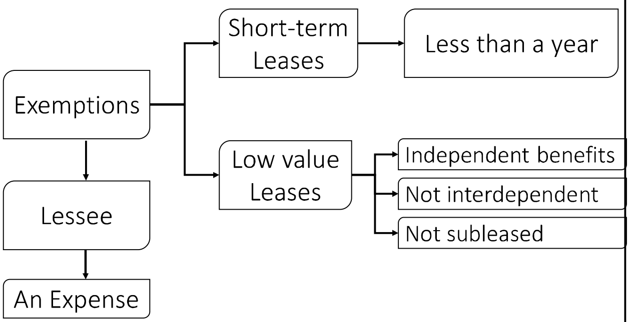

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What is Subleasing?

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Question 01

Namal PLC obtained a photocopy machine on 01/01/20X1 for a 08-month period based on a lease term.

Total lease expense of Rs. 80,000/- was fully paid on the date of entering the contract.

Show the accounting entries, assuming the accounting year ends on 31/03/20X1.

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Lease Expense paid in Advance

Cash Book

Lease Rental Expense Account

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Question 02

Dilki (Pvt) Ltd. has obtained the following assets under lease agreements. Identify the low value leases from the assets given below.

Asset	Is it a low value lease?
Motor Vehicle	
Office Building	
Office Computer	
Photocopy machine that has been subleased to another office	
Mobile Phone	

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Accounting for Leases
Step 03
Lessee Accounting

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Similar to acquiring an asset under a Long-term Loan

Lease Liability ← → Right-of-use Asset

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Lease Liability is

Present Value of the

Amount obligated

To pay the Lease Creditor

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Let's understand the Time Value of Money

Do you like to receive Rs. 100/- today or in another one year's time?

You like to receive it today!

Reasons
1. If you receive it today, you can invest it and earn an income.
2. Goods and services that can be purchased from Rs. 100/- today, cannot be purchased for the same price in another one year's time.
3. Money received today is certain. Receiving money in one year's time is uncertain.

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Therefore, if a sum of money is received in the future, for the

Investment Income that will be lost - **Opportunity Cost**

Decline in Real Value - **Inflation**

Uncertainty

An **Interest** is expected as compensation

Present Cash flows + Interest = Future Cash flows

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Discounting is defined as the process of **eliminating** the interest included in future cash flows.

Future Cash flow × Discounting Factor = Present Cash flow

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

r = Interest Rate

n = Time

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Question 03

Calculate the Present Values of the cash flows given below.
(Assume the interest rate as 10%)

Year	Future Cash Flow	Discounting Factor	Present Value	Interest
	A	B	C = A*B	D = A - C
0	100	1		
1	110	0.91		
2	121	0.83		
3	133	0.76		

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Initial Measurement of the Lease Liability

- Fixed Payments
- Variable Payments
  - Lease rental that varies depending on a particular factor (production units, income)
- Residual value guarantees
  - The value guaranteed to a lessor (by a party unrelated to the lessor) out of the asset's realization value at the end of the lease term.
- Exercise price of a purchase option if it is reasonably certain to exercise that option
- Penalties charged (if any) for early termination of the contract

Subsequent Measurement of the Lease Liability

Opening Lease Liability + Lease Interest − Lease Payments = Closing Lease Liability

Lease Interest = Lease Interest Rate × Lease Liability balance as at the beginning of the period

Right-of-use Asset is

The Right

Received by the Lessee

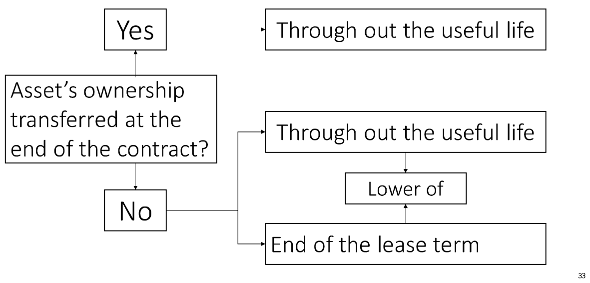
To direct the use of an underlying asset

Over the lease term

Initial Measurement of the Right-of-use Asset

- Initial Measurement of the Lease Liability
- Initial Down Payments (Lease prepayments)
- Initial Direct Costs
- Estimated costs to be incurred in dismantling and removing the asset at the end of the contract

Rule on Depreciating the Right-of-use Asset



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Subsequent Measurement of the Right-of-use Asset

Cost Model		Revaluation Model	
Cost	XX	Revalued Amount	XX
(-) Accumulated Depreciation	(X)	(-) Subsequent Accumulated Depreciation	(X)
(-) Accumulated Impairment Losses	(X)	(-) Subsequent Accumulated Impairment Losses	(X)
Net Book Value	**XX**	**Net Book Value**	**XX**

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Lessee Accounting

Description	Double Entry
Initial Payment	
Right-of-use the Asset account	Dr
Cash book	Cr
Amount recognized as the Lease Liability	
Right-of-use the Asset account	Dr
Lease Liability account	Cr

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Lessee Accounting

Description	Double Entry
Payment made as Initial Direct Cost	
Right-of-use the Asset account	Dr
Cash book	Cr
Annual Interest on lease	
Interest Expense account	Dr
Lease Liability account	Cr

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Lessee Accounting

Description	Double Entry
Payment of Lease Rental	
Lease Liability account	Dr
Cash book	Cr
Deprecation of Asset	
Depreciation account	Dr
Accumulated Depreciation account	Cr

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Presentation in the Statement of Financial Position

Right-of-use Asset → Non-current Asset

Lease Liability

Current Liability

Capital portion included in the next instalment

Next instalment − Interest included in the next instalment

Non-current Liability

Capital portion to be paid after next year

Total Lease Liability − Current portion

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Presentation in the Statement of Profit or Loss

Depreciation

Lease Interest

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Question 04

Vihanga obtained a motor vehicle on 01.04.20X7, under lease agreement with LB Finance PLC. According to the agreement,

Lease period - 05 years Down payment - Rs. 1,200,000/-

The remaining amount is to be paid in 05 equal installments of Rs. 1,000,000/- annually. All installments are to be paid in arrears (At the end of the year). The useful life is 08 years.

The present value of unpaid lease payments was Rs. 3,800,000/-.

Interest rate - 10%

The interest included in the 1st installment and 2nd installment is Rs. 380,000/- and Rs. 318,000/- respectively. Ownership transfers at the end of the lease term.

You are required to,

Show the accounting entries for the year ended 31.03.20X8 and the extracts of Statement of Financial Position and Statement of Profit or Loss for that date.

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Answer 04

Let's understand the information given.

Year	Down Payment	Lease Installments	Interest @ 20%	Loan Capital portion
0	1,200,000		0	
1		1,000,000	380,000	620,000
2		1,000,000	318,000	682,000
3		1,000,000		
4		1,000,000		
5		1,000,000		
Total	1,200,000	5,000,000	1,200,000	3,800,000

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Double Entries

Description	Debit	Credit
Down Payment		
Right-of-use the Asset	1,200,000	
Cash		1,200,000
Lease Liability (Loan capital portion)		
Right-of-use the Asset	3,800,000	
Lease Liability		3,800,000
Interest included in the 1st Installment		
Lease Interest	380,000	
Lease Liability		380,000

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Double Entries

Description	Debit	Credit
Payment of 1st Lease Instalment		
Lease Liability	1,000,000	
Cash		1,000,000
Depreciation of 1st Year		
Depreciation	1,000,000	
Accumulated Depreciaition		1,000,000

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Computation of Depreciation

Depreciation = (Depreciable Amount/Useful life)

Depreciation = [(Cost - Residual Value)/Useful life]

Depreciation = [(5,000,000 - 0)/5]

Depreciation = 1,000,000

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Right-of-use the Asset

Cash

Lease Liability

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Lease Interest

Depreciation

Accumulated Depreciation

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Presentation

Extract of Statement of Financial Position	Rs.
Non-current Assets	
Right-of-use the Asset	
Non-current Liabilities	
Lease Liability	
Current Liabilities	
Lease Liability	

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Presentation

Extract of Statement of Profit or Loss and Other Comprehensive Income	Rs.
Depreciation	
Lease Interest	

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Question No. 05

Osheeta Transport Services Ltd. has purchased a heavy vehicle for a value of Rs.6.5 million. Initial deposit of Rs.1.5 million was paid on 01st April 2017 and the company entered into a lease agreement with AB Bank Ltd. for the remaining value (Rs.5 million) on the same day. The terms of lease agreement are as follows:

Annual lease installment	1,473,959
Term	5 Years
Interest Rate	14.5% per annum
Lease rental due date	31st of March of each year

Question No. 05

The useful life of the vehicle is 5 years and the company uses the straight-line basis to depreciate.

You are required to:
Prepare the extracts of the statement of financial position as at 31st March 2018 and the statement of comprehensive income for the year ended 31st March 2018 in respect of the above. (Assume that lease rentals were paid on due dates) (05 marks)

Answers

Question No. 06

Zeena PLC (lessee) entered into a leasing agreement with ABC PLC (lessor) on 01st April 2019 to acquire a motor vehicle for a 3 year lease term. As per the lease agreement, Zeena PLC paid Rs.400,000/- at the commencement date of the lease and balance should be paid as an annual lease installment of Rs.1,413,600/- on 31st March each year. Implicit interest rate is 14%. As per the lease agreement, the ownership of the motor vehicle is transferred to Zeena PLC at the end of lease period.
(Note: Assume that lease rental was paid on due date.)

Question No. 06

You are required to:

Prepare the extract of the Statement of Financial Position as at 31st March 2020 of the lessee in respect of the above transaction.
(06 marks)

Answers

Question 07

Luckyland PLC obtained a machine from People's Leasing PLC under a lease agreement on 01.04.20X1. The present value of unpaid lease payments was Rs. 1,000,000/-. According to the lease agreement, Rs. 100,000/- has to be paid on 01.04.20X1. The balance has to be settled in 03 equal installments of Rs. 400,000/- annually. Installments have to be paid in arrears. Interest on lease is 10% per annum, calculated based on the opening loan value.

On 01.04.20X1 a cost of Rs. 100,000/- was incurred to transport and install the machine. The ownership of the asset does not transfer at the end of the lease term. The useful life of the machine is 4 years.

You are required to,

Show the accounting entries of Lucklyland PLC for the year 20X1/20X2 and extracts of Statement of Financial Position as at 31.03.20X2 and Statement of Profit or Loss.

Answer

Let's understand the information given.

Year	Down Payment	Lease Installments	Interest @ 10%	Loan capital portion
0	100,000			
1		400,000	1,000,000×10% 100,000	400,000-100,000 300,000
2		400,000	(1,000,000-300,000)×10% 70,000	400,000-70,000 330,000
3		400,000		
Total	100,000	1,200,000	200,000	1,000,000

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Double Entries

Description	Debit	Credit
Down Payment		
Right-of-use the Asset	100,000	
Cash		100,000
Initial Direct Costs		
Right-of-use the Asset	100,000	
Cash		100,000
Lease Liability (Loan Capital portion)		
Right-of-use the Asset	1,000,000	
Lease Liability		1,000,000

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Double Entries

Description	Debit	Credit
Interest included in the 1st Instalment		
Lease Interest	100,000	
Lease Liability		100,000
Payment of 1st Lease Instalment		
Lease Liability	400,000	
Cash		400,000
Depreciation of 1st year		
Depreciation	400,000	
Accumulated Depreciation		400,000

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Computation of Depreciation

The ownership of asset does not transfer at the end of the agreement. Therefore, it should be depreciated over the lease term, which is the lower of between the asset's useful life of 04 years and lease term of 03 years.

Depreciation = (Depreciable Amount/Lease term)

Depreciation = [(Cost - Residual Value)/Lease term]

Depreciation = [(1,200,000 - 0)/3]

Depreciation = 400,000

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Right-of-use the Asset

Cash

Lease Liability

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Lease Interest

Depreciation

Accumulated Depreciation

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Presentation

Extract of the Statement of Financial Position	Rs.
Non-current Assets	
Right-of-use the Asset	
Non-current Liabilities	
Lease Liability	
Current Liabilities	
Lease Liability	

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Presentation

Extract of the Statement of Profit or Loss and Other Comprehensive Income	Rs.
Depreciation	
Lease Interest	

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Question 08

Kesara PLC leased a machine from Sampath Leasing Ltd. On 01.04.20X1 Rs. 200,000/- was made as a down payment. The balance was agreed to be settled in 03 equal installments of Rs. 400,000/-. Interest rate is 10%.

Discounting factors are as follows:

Year 01 0.91
Year 02 0.83
Year 03 0.76

The useful life of the machine is 02 years. The ownership of the machine does not transfer at the end of the contract. The company uses the revaluation model for the machine. The machine was revalued as at 31.03.20X2, where the revalued amount was Rs. 800,000/-.

You are required to demonstrate how the above transaction should be reflected in the Financial Statement as at 31/03/20X2 and Statement of Profit or Loss for the year 20X1/X2.

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Answer

Let's compute present value of the unpaid lease payments

Year	Future Cash Flows	Discounting Factor	Present Value
1	400,000	0.91	364,000
2	400,000	0.83	332,000
3	400,000	0.76	304,000
Total	1,200,000		1,000,000

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66

Answer

Let's understand the information given.

Year	Down Payment	Lease Installments	Interest @ 10%	Loan capital portion
0	200,000			
1		400,000	1,000,000×10% 100,000	400,000-100,000 300,000
2		400,000	(1,000,000-300,000)×10% 70,000	400,000-70,000 330,000
3		400,000		
Total	200,000	1,200,000	200,000	1,000,000

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Double Entries

Description	Debit	Credit
Down Payment		
Right-of-use the Asset	200,000	
Cash		200,000
Lease Liability (Loan capital portion)		
Right-of-use the Asset	1,000,000	
Lease Liability		1,000,000
Interest included on the 1st Installment		
Lease Interest	100,000	
Lease Liability		100,000

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Double Entries

Description	Debit	Credit
Payment of 1st Lease Instalment		
Lease Liability	400,000	
Cash		400,000
Depreciation of 1st Year		
Depreciation	600,000	
Accumulated Depreciation		600,000
Transferring accumulated depreciation of revalued asset to Asset account		
Accumulated Depreciation	600,000	
Right-of-use the Asset		600,000

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Double Entries

Description	Debit	Credit
Accounting the Revaluation Gain		
Right-of-use the Asset	200,000	
Revaluation Reserve account (through Other Comprehensive Income)		200,000

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Computation of Depreciation

The ownership of the asset does not transfer at the end of the agreement.
Accordingly, it is depreciated over the useful life, which is the lower of between the asset's useful life of 02 years and lease term of 03 years.

Depreciation = (Depreciable Amount/Useful life)

Depreciation = [(Cost - Residual Value)/Useful life]

Depreciation = [(1,200,000 - 0)/2]

Depreciation = 600,000

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Computation of Revaluation Gain or Loss

Revalued Amount		800,000
(-) Carrying amount of the asset as at 31.03.20X2		
Cost of Right-of-use the Asset	1,200,000	
(-) Accumulated Depreciation	(600,000)	(600,000)
Revaluation Gain		200,000

Accounting for Revaluation Gain
As there are no prior year revaluation losses in relation to this asset, the total gain can be recognized in the Revaluation Reserve through the Statement of Other Comprehensive Income.

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Right-of-use the Asset

Cash

Lease Liability

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Lease Interest

Depreciation

Accumulated Depreciation

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Revaluation Reserve

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Presentation

Extract of Statement of Financial Position	Rs.
Non-current Assets	
Right-of-use the Asset	
Equity	
Revaluation Reserve	
Non-current Liabilities	
Lease Liability	
Current Liabilities	
Lease Liability	

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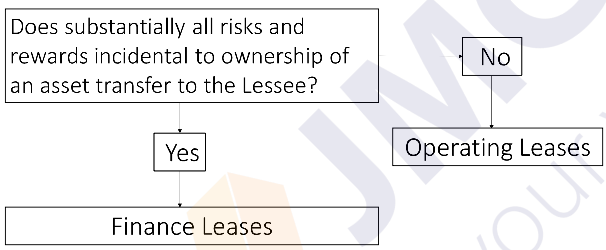
Presentation

Extract of Statement of Profit or Loss and Other Comprehensive Income	Rs.
Profit or Loss account	
Depreciation	
Lease Interest	
Statement of Other Comprehensive Income	
Revaluation Gain	

Accounting in Lessor's Books

From Lessor's perspective, leases are categorized into two types



What are these Risks and Rewards?

Risks	Rewards
• Damages • Technological Obsolescence • Repairs & maintenance • Losses arising from decrease in demand • Tax payments on assets	• Profits generated from using the assets • Profits generated from sale of assets • Increase in future market price of the asset • Tax benefits

Classification as Finance Lease or Operating Lease

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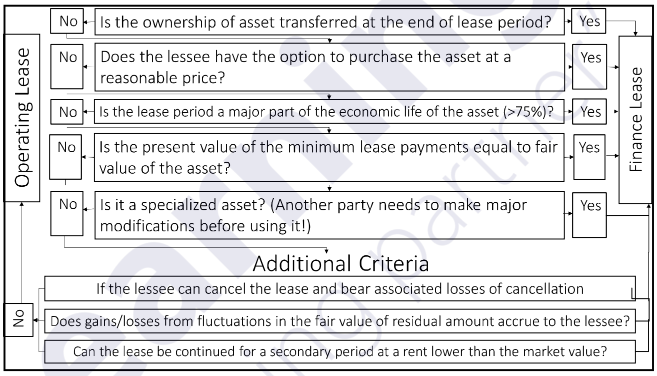

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Accounting for Operating Leases

Lease payments received shall be recognized as lease income based on a basis that is more representative of the benefits derived from the use of the asset (straight-line basis).

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Accounting for Finance Leases

- Step 01 - Derecognise the Carrying Amount of the Asset
- Step 02 - Recognise the Net Investment in the Lease
- Step 03 - Recognise the difference between the carrying amount of the asset and the net investment in the lease as a Selling Profit
- Step 04 - Recognise Interest Income over the lease term

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What is Net Investment in the Lease?

Amount received by discounting the Gross Investment in the Lease using the Interest Rate implicit in the lease		
Gross Investment in the Lease	(Unearned Finance Income)	Net Investment in the Lease
Total lease payments receivable	Interest income computed using the interest rate implicit in the lease	Present value of total lease payments receivables

Gross Investment in the Lease is

Down Payment	Amount payable when entering into a lease agreement
Lease Rental	Lease installments due to be paid
Guaranteed Residual Value	The guarantee given to a lessor by another party on the value of the asset at the end of the lease term
Unguaranteed Residual Value	The value not guaranteed on the realizable value at the end of the lease term

Example

A lessor expects the residual value of an asset at the end of the lease term to be Rs. 50,000/-. The lessor provides a guarantee for Rs. 30,000/- from the residual value. Accordingly, the guaranteed residual value will be Rs. 30,000/- and the unguaranteed residual value will be Rs. 20,000/-.

Double Entries

Recognition of the Net Investment in the Lease

Net Investment in the Lease Dr
Asset account Cr
Profit or Loss account Dr/Cr

Interest Income (computed through the lease amortization schedule)

Net Investment in the Lease Dr
Interest Income Cr

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Double Entries

Payment of Lease Installments

Cash Dr
Net Investment in the Lease Cr

Presentation

The capital portion included in the next installment of the net investment in the lease should be recognized as a current asset and the balance should be recognized as a non-current asset.

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We require a Lease Amortisation Schedule when accounting for leases. The structure of this schedule is given below.

Year	Opening Net Investment	Interest	Lease Payments received	Capital Repayments received	Closing Net Investment
A	B	C = B x r%	D	E = D - C	F = B - E

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Question No. 09

KEL Leasing Company (KEL) sold a Motor Vehicle to Perera under a finance lease agreement for a 5 year lease term on 01st January 2017. The cash selling price of the motor vehicle was Rs.2.5 million. Annual lease installment of Rs.781,409.75 is to be paid on 31st December each year at an annual lease interest rate of 17%. Perera has paid the lease installment on due date.

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Question No. 09

You are required to:

Prepare the following accounts as appearing in the books of KEL as at/for the year ended 31st December 2018:

(a) Lease Debtors Account.
(b) Interest Income Account. (06 marks)

Answers

Question 10

Janaka PLC leased a company-owned machine for 05 years to ABC Ltd. Under the agreement, Janaka PLC will receive Rs. 50,000/- at the end of each year. The residual value is expected to be Rs. 20,000/-. Janaka PLC has provided a guarantee of Rs. 12,000/- for the residual value. The interest rate implicit in the lease is 12.542%. The carrying value of the machine is Rs. 50,000/-.

Question 10

1. Calculate the gross investment in the lease.
2. Calculate the net investment in the lease.
3. Calculate the unearned finance income.
4. Calculate the selling profit or loss.
5. Prepare the lease amortization schedule.
6. Show the double entries for the 1st year using T accounts.
7. Show the extracts of financial statements at the end of the 1st year.

Answer

Question 11

Sasindu PLC has given a company-owned van for a 05 year period, under a leasing facility. The useful life of the van was also 05 years. The carrying amount was Rs. 5 Mn. The interest rate implicit in the lease was 10%. Installments are paid at the end of each year.
Assume there is no residual value. The fair value of the asset is Rs. 6 Mn.

Question 11

1. State whether this is an operating lease or a finance lease.
2. Calculate the value of a lease installment.
3. Prepare the lease amortization schedule.
4. Calculate the selling profit/loss of the asset.
5. Show the accounts of the 1st year using T accounts.
6. Show the extracts of financial statements for the 1st year.

Answer

- Disclosures
  - Amortisation
  - Interest
  - Lease Payments
  - Carrying amount of the Right-of-use the Asset
  - Additions to the Right-of-use the Asset