Ind AS 116

Worked Example

Finance Lease with guaranteed residual value in the books of the lessor

Worked Example

Ind AS 116 – Leases

Finance Lease with guaranteed residual value in the books of the lessor

SCENARIO

Entity A enters into a lease (on 1 April 20X1) of an equipment from Entity B that has a 6-year non-cancellable lease term. The estimated economic life of the equipment is 8 years. Entity A is required to pay CU 7,000 as annual lease payment at the end of each year. Entity A is required to pay Entity B at least CU 10,000 as residual value guarantee, when Entity A returns the equipment to Entity B at the end of 6^{th} year. As per the contract, the lease does not transfer title of the underlying asset to Entity A at the end of 6^{th} year or contain an option to purchase the equipment.

At the commencement date –

- Entity B classifies the leased equipment as finance lease, since it transfers substantially all the risks and rewards incidental to ownership of the equipment. (A lease is classified as a finance lease if at the inception date, the lease term is for the major part of the economic life of the underlying asset even if title is not transferred).
- The carrying amount of the equipment is CU 32,000 and its fair value is CU 35,000.
- Entity B uses the interest rate implicit in the lease @ 9% to measure the net investment in the lease.
- At the end of the lease term, the residual value of the equipment is CU 5,000.

At the commencement date, the present value of lease receivables is –

Date (31 Mar)	Cash inflow (CU)	Discount rate @ 9% p.a.	Present value (CU)
20X2	7,000	0.917	6,420
20X3	7,000	0.842	5,895
20X4	7,000	0.772	5,405
20X5	7,000	0.708	4,957
20X6	7,000	0.650	4,550
20X7	17,000 *	0.596	10,133
	52,000	**Net investment in the lease**	**37,360**

* Includes CU 10,000 as guaranteed residual value.

At the inception date, the present value of the lease receivables amounts to at least substantially all of the fair value of the underlying asset. Here, the present value of the lease receivables is CU 37,360, which is more than the fair value (CU 35,000). Therefore, the condition is satisfied. **[Refer para 63 (d) of Ind AS 116.]**

A lessor shall recognise 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. **[Refer para 75 of Ind AS 116.]**

The lease receivables from 31 March 20X2 to 31 March 20X7 is –

Date (31 Mar)	Balance bf (CU)	Finance income @ 9% p.a. (CU)	Receipt (CU)	Balance cf (CU)
20X2	37,360	3,363	7,000	33,723
20X3	33,723	3,035	7,000	29,760
20X4	29,760	2,678	7,000	25,438
20X5	25,438	2,290	7,000	20,728
20X6	20,728	1,865	7,000	15,593
20X7	15,593	1,407	12,000	– *

*At the end of the lease term, the residual value guarantee of the equipment is CU 10,000, but the residual value of the equipment is CU 5,000. Therefore, only CU 5,000 (CU 10,000 – CU 5,000) is receivable. The balance of CU 5,000 is transferred to profit and loss.

Journal

20X1 – X2

Under a finance lease, the lessor accounts for its investment as the amount receivable rather than the underlying asset itself that is subject of the finance lease. Therefore, at the commencement date on 1 April 20X1, Entity B recognises the equipment held under a finance lease in its balance sheet and presents that as a receivable (ie, as a financial asset) at an amount equal to the net investment in the lease –

• Lease receivable (net investment in the lease)	CU 37,360	
Property, plant and equipment (derecognised)		CU 32,000
Profit and loss (gain on lease)		CU 5,360

At the end of the year on 31 March 20X2, Entity B recognises –

• *Finance income on lease receivable*		
Lease receivable	CU 3,363	
Finance income		CU 3,363
• *Receipt of lease receivable*		
Cash	CU 7,000	
Lease receivable		CU 7,000
• *Recognition in profit and loss*		
Finance income	CU 3,363	
Profit and loss		CU 3,363

20X2 – X3

At the end of the year on 31 March 20X3, Entity B recognises –

- *Finance income on lease receivable*

Lease receivable	CU 3,035	
Finance income		CU 3,035

- *Receipt of lease receivable*

Cash	CU 7,000	
Lease receivable		CU 7,000

- *Recognition in profit and loss*

Finance income	CU 3,035	
Profit and loss		CU 3,035

20X3 – X4

At the end of the year on 31 March 20X4, Entity B recognises –

- *Finance income on lease receivable*

Lease receivable	CU 2,678	
Finance income		CU 2,678

- *Receipt of lease receivable*

Cash	CU 7,000	
Lease receivable		CU 7,000

- *Recognition in profit and loss*

Finance income	CU 2,678	
Profit and loss		CU 2,678

20X4 – X5

At the end of the year on 31 March 20X5, Entity B recognises –

- *Finance income on lease receivable*

Lease receivable	CU 2,290	
Finance income		CU 2,290

- *Receipt of lease receivable*

Cash	CU 7,000	
Lease receivable		CU 7,000

- *Recognition in profit and loss*

Finance income	CU 2,290	
Profit and loss		CU 2,290

20X5 – X6

At the end of the year on 31 March 20X6, Entity B recognises –

- *Finance income on lease receivable*

Lease receivable	CU 1,865	
Finance income		CU 1,865

- *Receipt of lease receivable*

Cash	CU 7,000	
Lease receivable		CU 7,000

- *Recognition in profit and loss*

Finance income	CU 1,865	
Profit and loss		CU 1,865

20X6 – X7

At the end of the year on 31 March 20X7, Entity B recognises –

- *Finance income on lease receivable*

Lease receivable	CU 1,407	
Finance income		CU 1,407

- *Receipt of lease receivable*

Cash	CU 12,000 *	
Profit and loss	CU 5,000	
Lease receivable		CU 17,000

* [Lease payment (CU 7,000) and residual value guarantee (CU 10,000 – CU 5,000)]

- *Recognition in profit and loss*

Finance income	CU 1,407	
Profit and loss		CU 1,407

Presentation

Balance Sheet as at 31 March (Extract) (CU)

	20X2	20X3	20X4	20X5	20X6	20X7
Lease receivable						
Current	3,035	2,678	2,290	1,865	15,593	–
Non-current	30,688	27,082	23,148	18,863	–	–

Statement of Profit and Loss for the year ended 31 March (Extract) (CU)

	20X2	20X3	20X4	20X5	20X6	20X7
Income						
Gain on lease	5,360	–	–	–	–	–
Finance income	3,363	3,035	2,678	2,290	1,865	1,407

Statement of Cash Flows for the year ended 31 March (Extract) (CU)

	20X2	20X3	20X4	20X5	20X6	20X7
Cash flows from operating activities						
Gain on lease	(5,360)	–	–	–	–	–
Finance income	(3,363)	(3,035)	(2,678)	(2,290)	(1,865)	(1,407)
Cash flows from investing activities						
Proceeds from finance lease	7,000	7,000	7,000	7,000	7,000	12,000

Disclosures for the year ended 31 March (Extract) **(CU)**

	20X2	20X3	20X4	20X5	20X6	20X7
Gain on lease	5,360	–	–	–	–	–
Finance income	3,363	3,035	2,678	2,290	1,865	1,407

According to **paragraph 92 of Ind AS 116**, "a lessor shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the above disclosure objective. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

a) the nature of the lessor's leasing activities; and
b) how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. Such means may include, eg, buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits."

Also, as per **parapraph 93 of Ind AS 116** states that "A lessor shall provide a qualitative and quantiative explanation of the significant changes in the carrying amount of the net investment in finance leases."

Maturity analysis

In accordance with **paragraph 94 of Ind AS 116**, "A lessor shall disclose a *maturity analysis* of the lease payments receivable, showing 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." This will enable users of financial statements to more accurately forecast future lease cash flows and estimate liquidity risk (ie, the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset).

(CU)

Year	Lease payments receivable (undiscounted)
1: 20X2	7,000
2: 20X3	7,000
3: 20X4	7,000
4: 20X5	7,000
5: 20X6	7,000
6: 20X7	17,000

Paragraph 94 of Ind AS 116 also states that "A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value."

Unearned finance income
= Undiscounted lease payments – net investment in the lease
= CU 52,000 – CU 37,360 = CU 14,640

Unearned finance income

Year	Opening balance (CU)	Amount recognised (CU)	Closing balance (CU)
20X2	14,640	3,363	11,277
20X3	11,277	3,035	8,242
20X4	8,242	2,678	5,564
20X5	5,564	2,290	3,274
20X6	3,274	1,865	1,409
20X7	1,409	1,409	–

Additional considerations

As per **paragraph 5.5.15 of Ind AS 109**, "…an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for lease receivables that result from transactions that are within the scope of Ind AS 116, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses."

According to **paragraph B5.5.34 of Ind AS 109**, "When measuring a loss allowance for a lease receivable, the cash flows used for determining the expected credit losses should be consistent with the cash flows used in measuring the lease receivable in accordance with Ind AS 116."

Paragraph 5.5.16 of Ind AS 109 states that, "an entiy may select its accounting policy for lease receivables independently of each other."

For more Examples, Case Studies and a Complete Guide on the lease accounting standard, see our latest comprehensive e-Book on Ind AS 116 ONLY on

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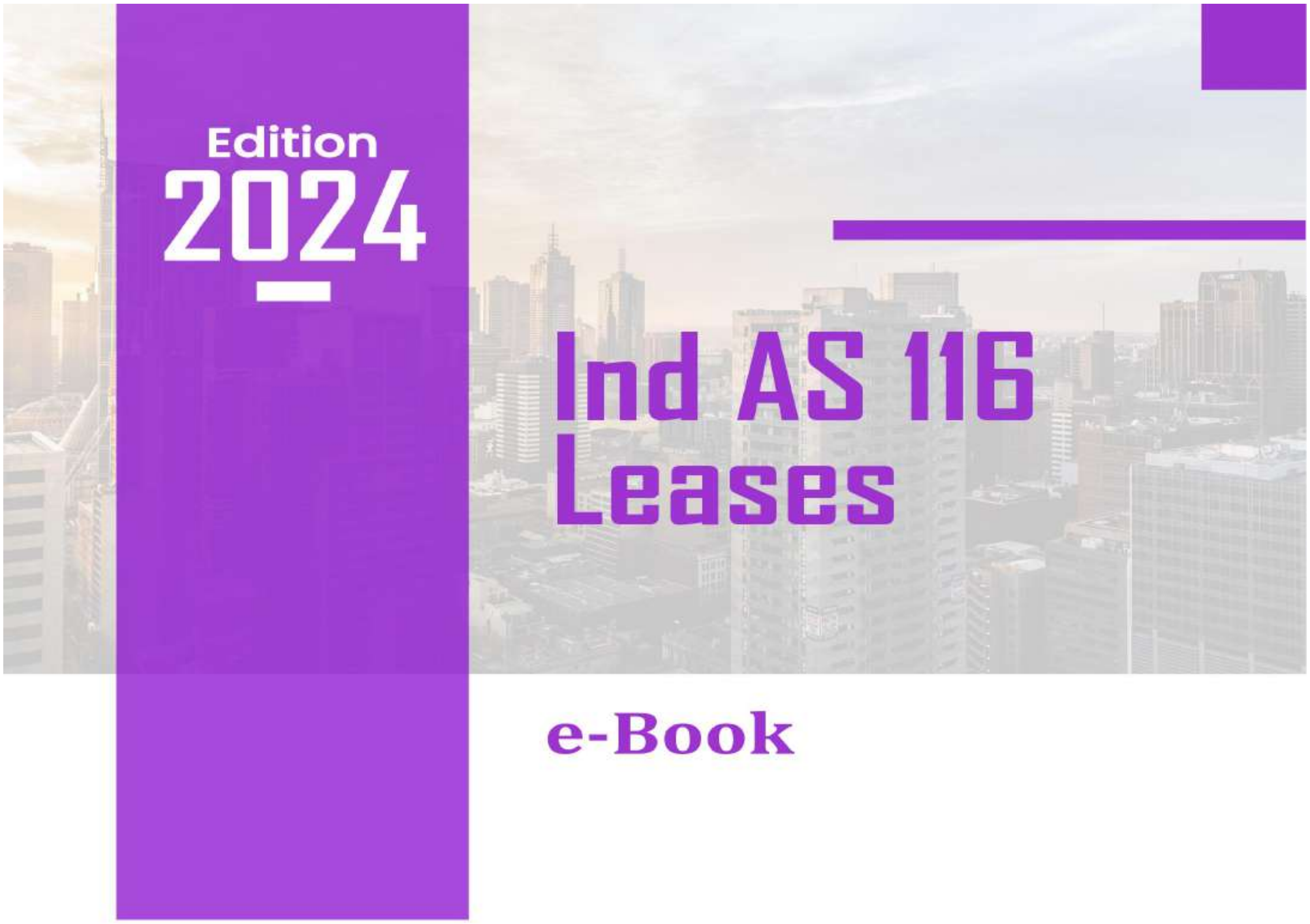

Contains:

- **Detailed commentary on the application of the standard written in a clear and simple language**
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