Edition 2024

Ind AS 116 Leases

e-Book

Contains:

- Detailed commentary on the application of the standard written in a clear and simple language
- 50+ practical numerical examples illustrated with journal entries to show the effect of these new reporting rules
- 7 case studies demonstrating the accounting treatment from both the lessor and lessee perspective
- Includes the latest amendment relating to Sale and Leaseback Transactions NEW

Ind AS 116: Leases

e-Book

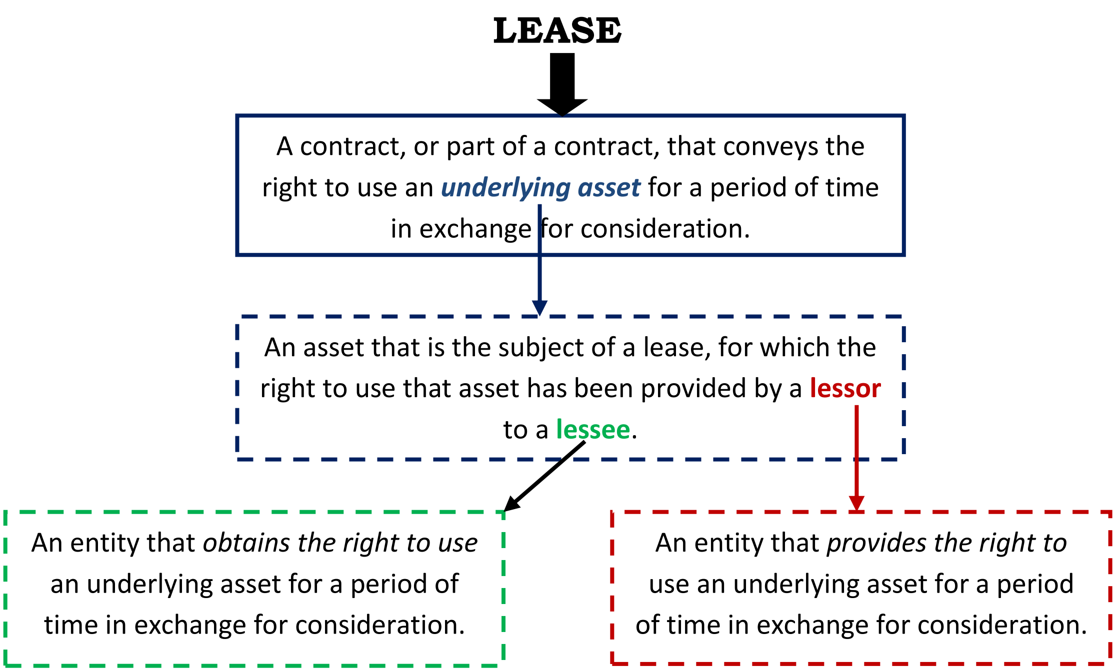
Preview

This is a preview of the e-book and does not contain the full e-book

Ind AS 116
Leases

Introduction

A **lease** is a contract (ie, an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to use an asset (the underlying asset, ie, an asset that is subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee) for a period of time in exchange for consideration. A **lessor** is an entity that provides the right to use an underlying asset for a period of time in exchange for consideration. A **lessee** is an entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.



Objective

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 cash flows of an entity.

An entity shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

Scope

Ind AS 116 applies to all leases, including leases of right-of-use assets in a sublease, except for the following—

(a) Leases to explore for, or use minerals, oil, natural gas and similar non-regenerative resources;

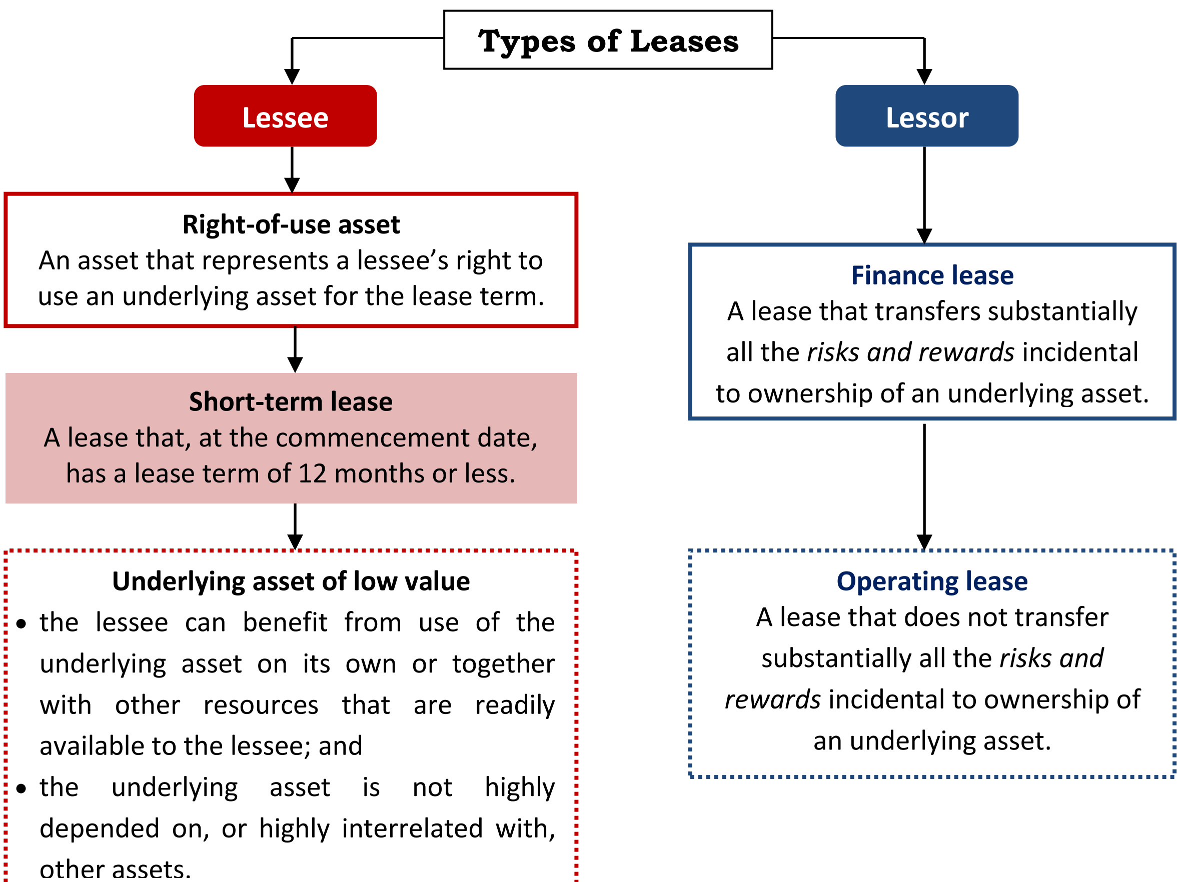
(b) Leases of biological assets within the scope of Ind AS 41 *Agriculture* held by a lessee;

(c) Service concession arrangements within the scope of Appendix D, *Service Concession Arrangements* of Ind AS 115 *Revenue from Contracts with Customers*.

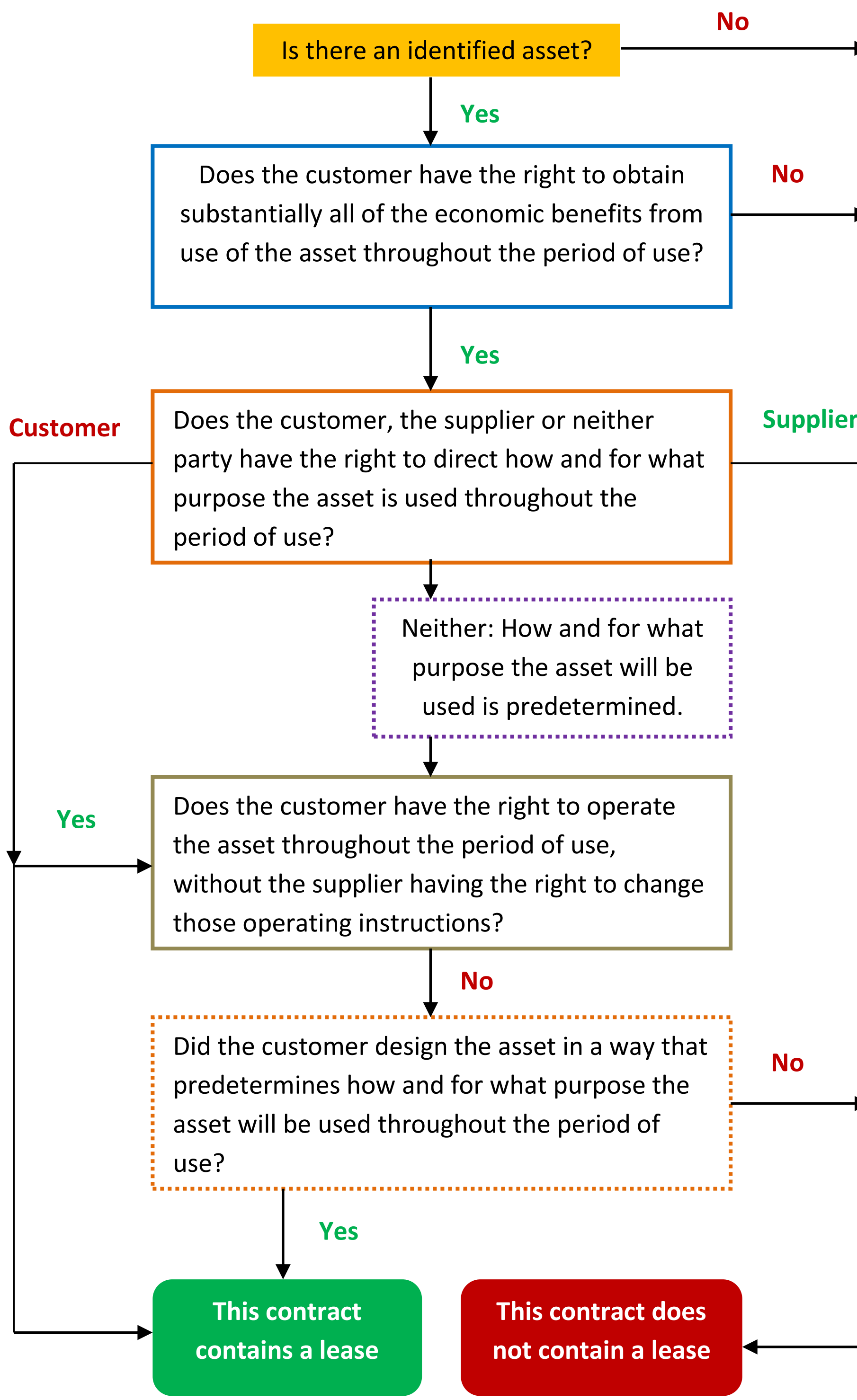
(d) Licences of intellectual property granted by a lessor within the scope of Ind AS 115; and

(e) Rights held by lessee under licensing agreements within the scope of Ind AS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph (e) above.



The following flow chart may assist entities in making the assessment of whether a contract is, or contains, a lease :



Example 22

Entity A enters into a 3-year lease of equipment, with fixed annual payments of CU 30,000 – the break-up of which is as follows –

- CU 22,500 for rent;
- CU 6,250 for repairs and maintenance; and
- the balance of CU 1,250 for administrative tasks.

The contract contains one lease component (ie, lease of equipment) and another non-lease component (ie, maintenance of the equipment). The amount paid for administrative tasks does not transfer a good or service to Entity A.

Worked Example 1

Entity A enters into a 5-year lease with Entity B of an equipment. The lease payment is CU 1,600 per annum. The contract includes additional maintenance cost of CU 200 per annum. Payments are to be made at the end of each year. The stand alone prices of lease and maintenance cannot be readily observed. Therefore, Entity A makes estimates, maximising the use of observable information, of the lease and maintenance (non-lease component), as under –

Lease	CU 1,700
Maintenance	CU 300

Entity A allocates the consideration in the contract (CU 1,800) as under –

Lease (CU 1,800 x 85%)	CU 1,530
Maintenance (CU 1,800 x 15%)	CU 270
	CU 1,800

Entity A includes the present value of the five annual payments of CU 1,530 in the initial measurement of the lease liability by applying the interest rate implicit in the lease or the Entity A's incremental borrowing rate. Entity A excludes the maintenance costs from the lease liability. Using a discount rate of 7%, the lease liability at the commencement date is calculated as under –

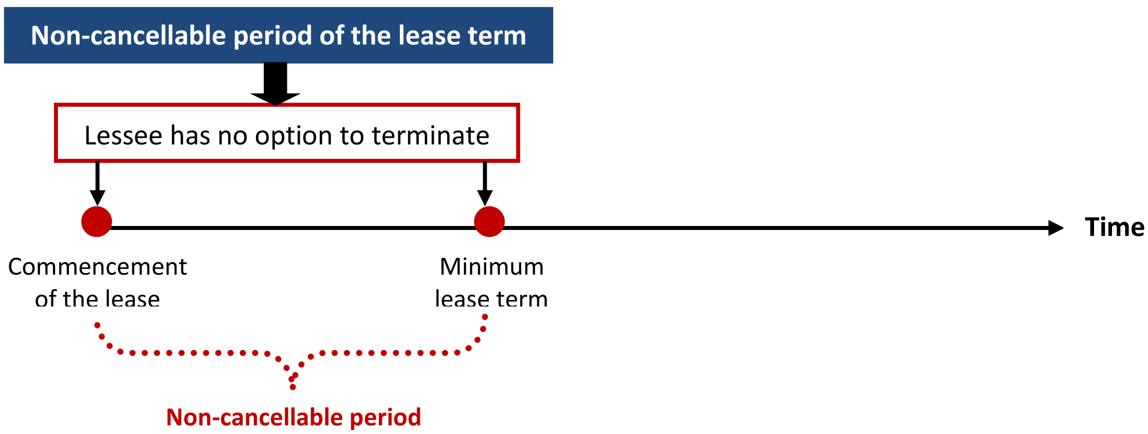
Date (31 Dec)	Cash outflow (CU)	Discount rate @ 7% p.a.	Present value (CU)
20X1	1,530	0.9346	1,430
20X2	1,530	0.8734	1,336
20X3	1,530	0.8163	1,249
20X4	1,530	0.7629	1,167
20X5	1,530	0.7130	1,090
	Initial measurement of the lease liability		**6,272**

Lease term

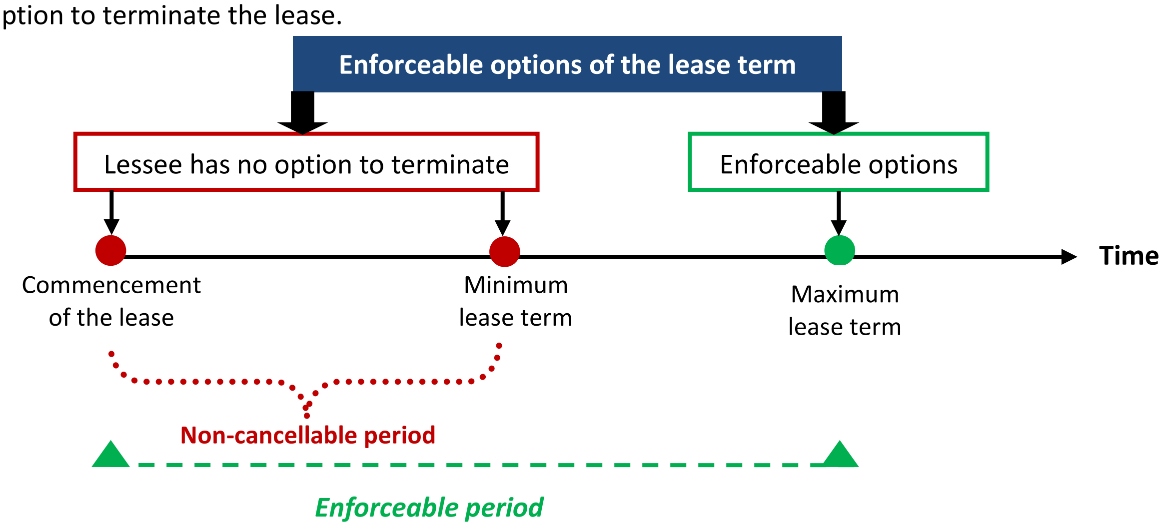
The non-cancellable period for which a lessee has the right to use an underlying asset, together with both –

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

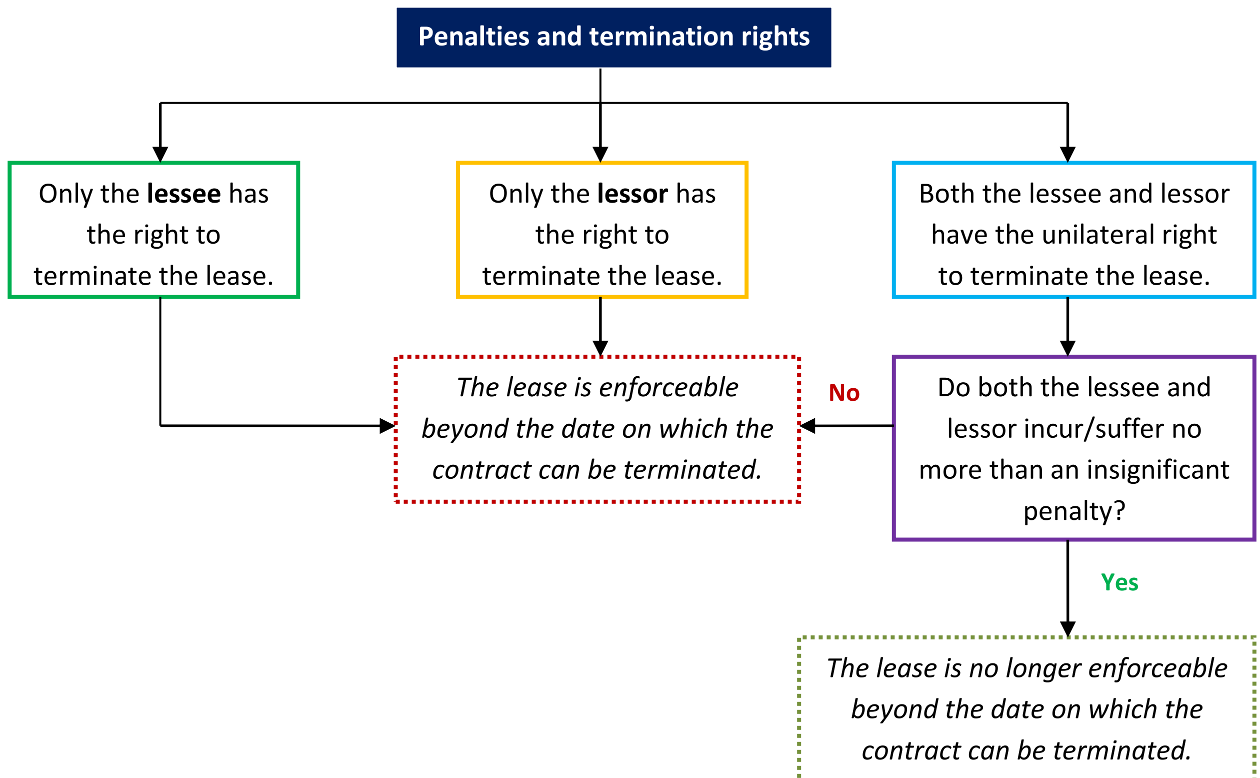


In assessing whether a lessee is reasonably certain to exercise as option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease.



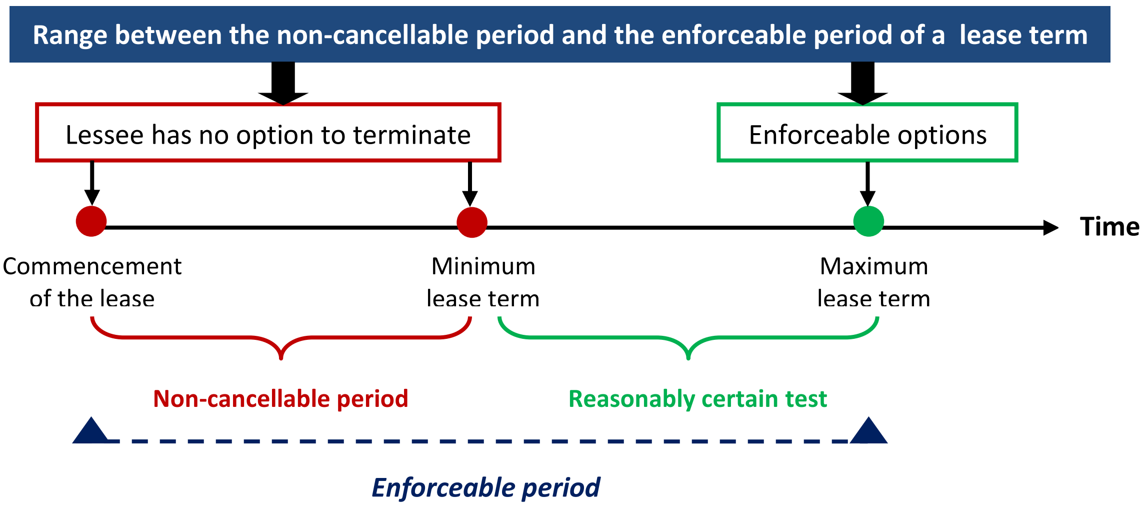
shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

A contract would be considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. To be a part of a contract, any options to extend or terminate the lease that are included in the lease term must also be enforceable; eg, the lessee must be able to enforce its right to extend the lease beyond the non-cancellation period. If optional periods are not enforceable, eg, if the lessee cannot enforce the extension of the lease without the agreement of the lessor, the lessee does not have the right to use the asset beyond the non-cancellable period. Consequently, by definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease.



If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellation period of lease includes the period covered by the option to terminate the lease.

If the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.



Worked Example 2

Entity A enters into a lease with Entity B for an equipment for a period of 5 years. The lease agreement includes that if Entity A uses the equipment within a given month, a lease liability of CU 2,500 is payable for that month. If the equipment is not used within a given month, then an amount of CU 1,500 is payable for the month. The lease payments are required to be made at the end of each year.

Entity A considers that there is a possibility that it may not use the equipment in some months. Since a minimum payment of CU 1,500 per month is payable, when the equipment is not used, there is an *in-substance fixed payment*, which is to be included in the measurement of the lease liability.

At the commencement date, the lease liability is calculated as follows (assuming a discount rate of 6%) –

Year-end	Lease payment (CU 1,500 x 12)	Discounted lease payment (CU)	
1	CU 18,000	CU 18,000 x 0.94340 =	CU 16,980
2	CU 18,000	CU 18,000 x 0.89000 =	CU 16,020
3	CU 18,000	CU 18,000 x 0.83962 =	CU 15,113
4	CU 18,000	CU 18,000 x 0.79210 =	CU 14,258
5	CU 18,000	CU 18,000 x 0.74726 =	CU 13,451
	Lease liability at commencement date		**CU 75,822**

Journal

1. Right-of-use asset	CU 75,822	
Lease liability		CU 75,822

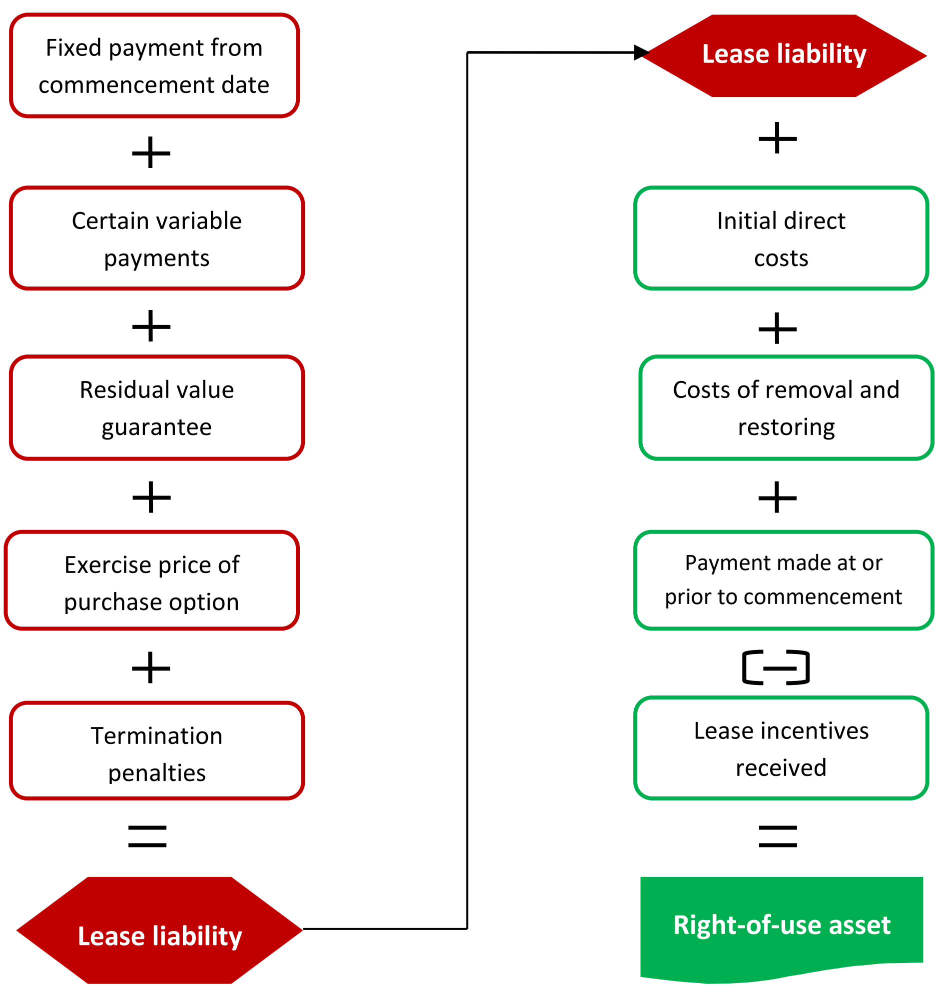
(Lease at commencement date recognised)

Upto the end of year 1, Entity A uses the equipment for 3 months only.

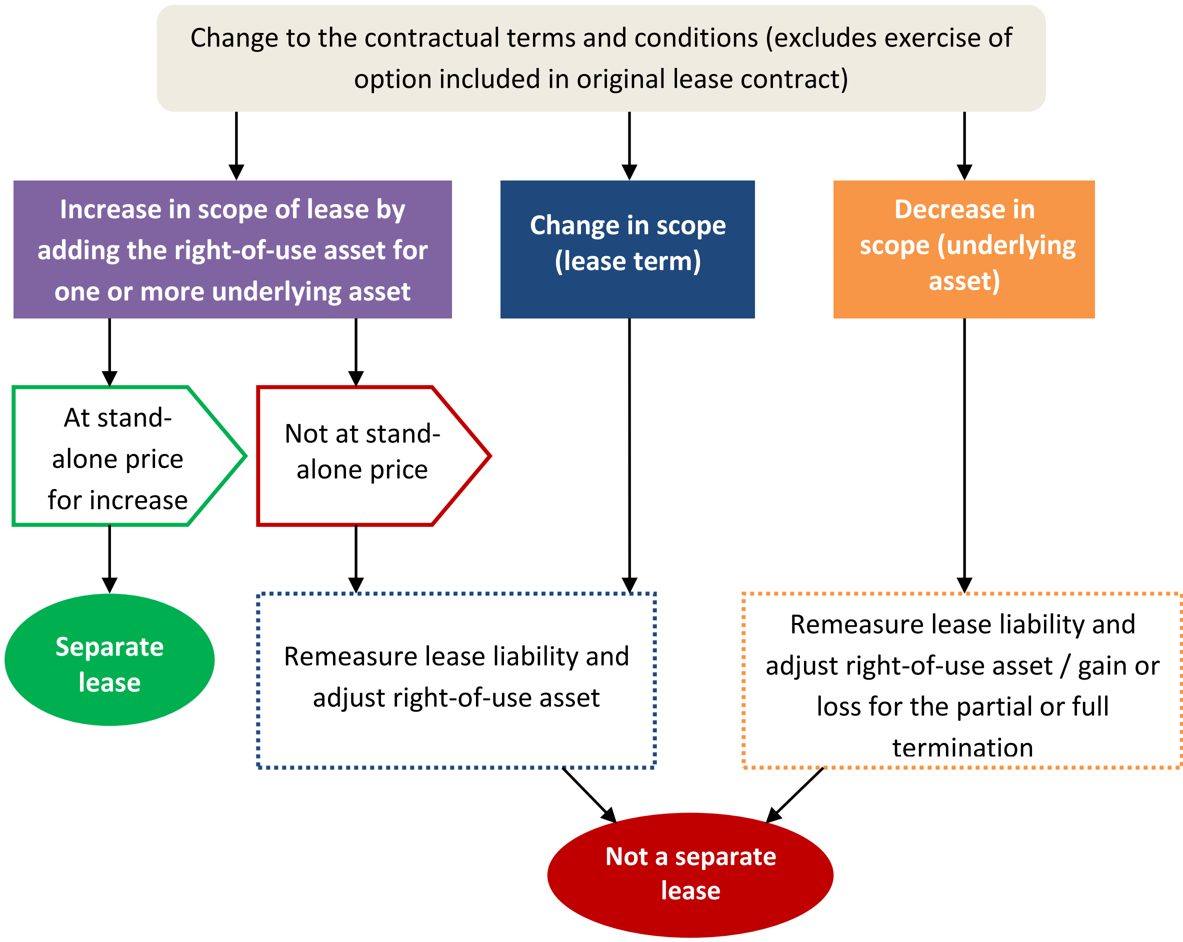
Journal

1.	Depreciation	CU 15,164 (CU 75,822 ÷ 5)	
	Provision for depreciation		CU 15,164
2.	Lease expense	CU 3,000 [(2,500 – 1,500) x 3]	
	Interest expense	CU 4,550 (75,822 x 6%)	
	Lease liability	CU 13,450 (18,000 – 4,550)	
	Cash (lease payment)		CU 21,000
3.	Profit or loss	CU 7,550	
	Lease expense		CU 3,000
	Interest expense		CU 4,550

Initial Recognition of Lease Liability and Right-of-use Asset



Lease modification by a lessee



For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification [ie, 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 (eg, adding or terminating the right to use one or more underlying assets, or extending the shortening the contractual lease term)], a lessee shall –

(a) allocate the consideration in the modified contract;
(b) determine the lease term of the modified lease; and
(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

Steps for accounting for a modification that is not a separate lease at the effective date of the modification

1 • Allocate the consideration in the modified contract.

2 • Determine the lease term of the modified lease.

3 • Remeasure the lease liability - revised payments discounted using a revised discount rate.

4 • Account for the remeasurement of the lease liability.

Partial or full termination (decrease in scope)

Decrease the carrying amount of the right-of-use asset. Recognise the gain or loss in profit or loss.

All other modifications

Adjust the right-of-use asset.

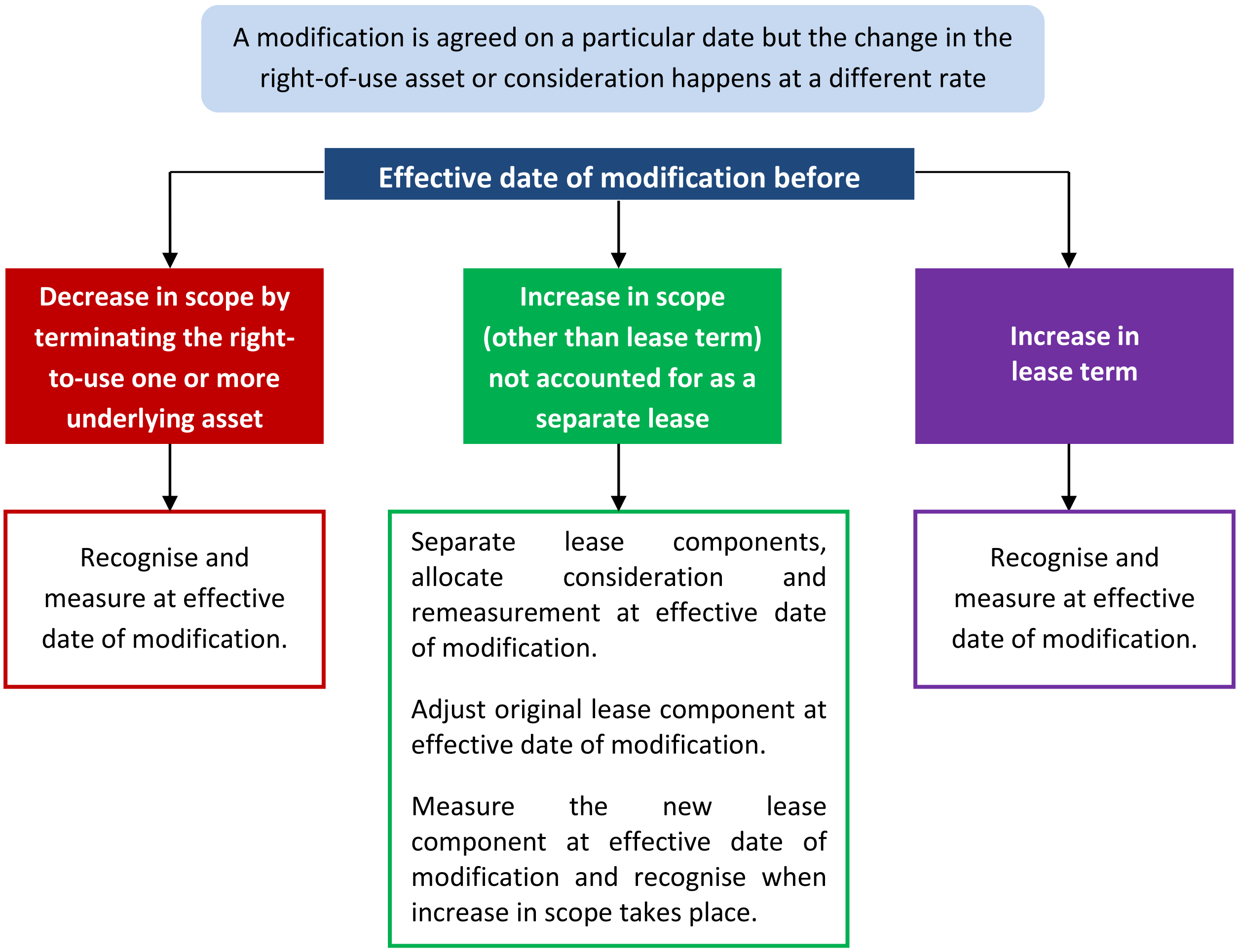
Example 36

Entity A enters into a lease contract with Entity B to lease a floor space in an office building for 8 years. At the end of the year 5, Entity A determines that it requires additional office space, since the business is growing. At the beginning of year 6, the lease contract is amended to grant Entity A the right to use another floor space in the same office building for 4 years. The new office space is identical in all respect with the existing office space.

Entity A has to pay market rates for the lease payments for the new office space, but a discount of 10% is allowed by Entity B, because of cost savings (ie, costs that would have been incurred if the new floor space had been leased to a new tenant, eg, marketing costs).

At the effective date of lease modification (ie, the date when both parties agree to a lease modification), Entity A accounts for this modification as a separate lease because the modification increases the scope of the lease by adding the right to use an additional office space. Moreover, the lease payments for the new office space are commensurate with market rentals for office space of that size and characteristics.

Effective date of a lease modification



Worked Example 9

Entity A enters into a lease 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 pay Entity B CU 10,000 as residual value guarantee, when Entity A returns the equipment to Entity B at the end of 6th year. As per the contract, the lease does not transfer title of the underlying asset to Entity A at the end of 6th 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, the residual value of the equipment is CU 5,000.

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

Date (31 Dec)	Cash inflow (CU)	Discount rate @ 9% p.a.	Present value (CU)
20X1	7,000	0.917	6,420
20X2	7,000	0.842	5,895
20X3	7,000	0.772	5,405
20X4	7,000	0.708	4,957
20X5	7,000	0.650	4,550
20X6	17,000*	0.596	10,133
		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 receipts amounts to at least substantially all of the fair value of the underlying asset. Here, the present value of the lease receipts is CU 37,360, which is more than the fair value (CU 35,000). Therefore, the condition is satisfied.

The lease receivable from 31 December 20X1 to 31 December 20X6 is –

Date (31 Dec)	Balance bf (CU)	Finance income @ 9% p.a. (CU)	Receipt (CU)	Balance cf (CU)
20X1	37,360	3,363	(7,000)	33,723
20X2	33,723	3,035	(7,000)	29,760
20X3	29,760	2,678	(7,000)	25,438
20X4	25,438	2,290	(7,000)	20,728
20X5	20,728	1,865	(7,000)	15,593
20X6	15,593	1,407	(12,000)	–*

*At the end of the lease, 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 or loss.

Journal

20X1

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

	Dr	Cr
➢ Lease receivable (net investment in the lease)	CU 37,360	
Property, plant and equipment		CU 32,000
Profit and loss (balancing figure)		CU 5,360

At the end of the year on 31 December 20X1, Entity B recognises –

	Dr	Cr
➢ *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 or loss*		
Finance income	CU 3,363	
Profit or loss		CU 3,363

20X2

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

	Dr	Cr
➢ *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 or loss*		
Finance income	CU 3,035	
Profit or loss		CU 3,035

20X3

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

	Dr	Cr
➢ *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 or loss*

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

20X4

At the end of the year on 31 December 20X4, 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 or loss*

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

20X5

At the end of the year on 31 December 20X5, 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 or loss*

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

20X6

At the end of the year on 31 December 20X6, 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 or 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 or loss*

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

Case Study 1

Entity A (Lessee)

Entity A enters into a lease of a machine from Entity B that has a 3-year non-cancellable initial lease term with an additional 3-year renewal option. Entity A is required to pay CU 10,100 at the commencement date of the lease on 1 January 20X1 and annual lease payments of CU 5,000 payable at the end of each year. The contract specifies that lease payments will increase, if the contract is renewed, on the basis of the increase in the Consumer Price Index (CPI) for the preceding 3 years. The CPI at the commencement date is 100. The contract also specifies that in case the renewal option is not exercised, Entity A is required to pay Entity B CU 2,000 as penalty for terminating the lease, when Entity A returns the machine to Entity B at the end of 3rd year. If the contract is renewed, Entity A is required to pay Entity B CU 3,000 as residual value guarantee at the end of the 6th year, when Entity A returns the machine to Entity B. Entity A is also required to make variable lease payments for each year of the lease, which are determined as 2% of Entity A's sales generated from the leased machine. At the end of the lease, the residual value of the machine is insignificant.

At the commencement date, Entity A concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term is 3 years. The interest rate implicit in the lease is not readily determinable. Entity A's incremental borrowing rate is 9% p.a., which reflects the fixed rate at which Entity A could borrow an amount similar to the value of the right-of-use asset in the same currency, for a 3-year term and with similar collateral.

Entity A expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis. At the commencement date, Entity A incurs initial direct costs of CU 2,700. Entity A generates sales from the leased machine as under–

31 December 20X1 : CU 50,000, 31 December 20X2 : CU 60,000; 31 December 20X3 : CU 75,000.

The present value of future lease payments using 9% incremental borrowing rate is –

Date (31 Dec)	Cash outflow (CU)	Discount rate @ 9% p.a.	Present value (CU)
20X1	5,000	0.917	4,585
20X2	5,000	0.842	4,210
20X3	7,000*	0.772	5,405
	Initial measurement of lease liability		**14,200**

* Includes CU 2,000 as penalty for terminating the lease.

Subsequent to initial measurement, lease liabilities increase as a result of interest charged at a constant rate on the balance outstanding and decrease for lease payments made.

After the commencement date, a lessee shall recognise in profit or loss, the following –

- interest on the lease liability; and

- variable lease payments not included in the measurement of lease liability in the period in which the event or condition that triggers these payments occurs.

The lease liabilities from 31 December 20X1 to 31 December 20X3 are –

Date (31 Dec)	Balance bf (CU)	Interest @ 9% p.a. (CU)	Payment (CU)	Balance cf (CU)
20X1	14,200	1,278	(5,000)	10,478
20X2	10,478	943	(5,000)	6,421
20X3	6,421	579	(5,000) **	2,000

** At the end of the 3rd year, Entity A determines that there is a significant economic incentive to exercise the 3-year renewal option. In effect, penalty for terminating the lease does not arise.

Right-of-use Asset	**CU**
Lease payment at the commencement date	10,100
Initial measurement of lease liability (as above)	14,200
Initial direct costs	2,700
Initial measurement of right-of-use asset *	**27,000**

* Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments. The carrying amount of the right-of-use asset decreases with depreciation charged each period.

The right-of-use asset from 1 January 20X1 to 31 December 20X3 is –

Date (31 Dec)	Balance bf (CU)	Depreciation (CU)	Balance cf (CU)
20X1	27,000	(9,000)	18,000
20X2	18,000	(9,000)	9,000
20X3	9,000	(7,000)	2,000

Journal

20X1

At the commencement date on 1 January 20X1, Entity A recognises a right-of-use asset and a lease liability –

➢ Right-of-use asset	CU 27,000	
Cash (lease payment at the commencement date)		CU 10,100
Lease liability		CU 14,200
Cash (initial direct costs)		CU 2,700

At the end of the year on 31 December 20X1, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 1,278	

Lease liability		CU 1,278

- *Lease payment*

Lease liability	CU 5,000	
Cash		CU 5,000

- *Variable lease payment* *

Lease expense	CU 1,000 (50,000 x 2%)	
Cash		CU 1,000

* A lessee's liability to make variable lease payments does not exist until the future event requiring the payment occurs (eg, in this case, a sale is made). Therefore, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset.

- *Depreciation of the right-of-use asset*

Depreciation	CU 9,000	
Accumulated depreciation		CU 9,000

- *Recognition in profit or loss*

Profit or loss	CU 11,278	
Interest expense		CU 1,278
Lease expense		CU 1,000
Depreciation		CU 9,000

20X2

At the end of the year on 31 December 20X2, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 943	
Lease liability		CU 943

- *Lease payment*

Lease liability	CU 5,000	
Cash		CU 5,000

- *Variable lease payment*

Lease expense	CU 1,200 (60,000 x 2%)	
Cash		CU 1,200

- *Depreciation of the right-of-use asset*

Depreciation	CU 9,000	
Accumulated depreciation		CU 9,000

- *Recognition in profit or loss*

Profit or loss	CU 11,143	
Interest expense		CU 943
Lease expense		CU 1,200
Depreciation		CU 9,000

20X3

At the end of the year on 31 December 20X3, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 579	
Lease liability		CU 579

- *Lease payment*

Lease liability	CU 5,000	
Cash		CU 5,000

- *Variable lease payment*

Lease expense	CU 1,500 (75,000 x 2%)	
Cash		CU 1,500

- *Depreciation of the right-of-use asset*

Depreciation	CU 7,000	
Accumulated depreciation		CU 7,000

- *Recognition in profit or loss*

Profit or loss	CU 9,079	
Interest expense		CU 579
Lease expense		CU 1,500
Depreciation		CU 7,000

At the beginning of the year on 1 January 20X4, the CPI is 120. During the original period, Entity A's incremental borrowing rate is unchanged at 9% p.a. and there is no change in the amounts expected to be payable under residual value guarantee. Entity A generates sales from the leased machine as under –

31 December 20X4: CU 80,000; 31 December 20X5: CU 90,000; 31 December 20X6: CU 100,000.

The present value of lease payments using 9% incremental borrowing rate is –

Date (31 Dec)	Cash outflow (CU)	Discount rate @ 9% p.a.	Present value (CU)
20X4	6,000*	0.917	5,500
20X5	6,000*	0.842	5,050
20X6	9,000**	0.772	6,950
	Subsequent measurement of lease liability		**17,500**

*Adjusted for CPI (CU 5,000 ÷ 100 x 120)

**It is expected that it will owe Entity B CU 3,000 under the residual value guarantee. Entity A includes that amount as a lease payment.

The lease liabilities from 31 December 20X4 to 31 December 20X6 are –

Date (31 Dec)	Balance bf (CU)	Interest @ 9% p.a. (CU)	Payment (CU)	Balance cf (CU)
20X4	17,500	1,575	(6,000)	13,075
20X5	13,075	1,177	(6,000)	8,252
20X6	8,252	748	(9,000)	–

Right-of-use Asset	**CU**
Subsequent measurement of the lease liability	17,500
Subsequent measurement of right-of-use asset	17,500

A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if there is a change in the lease term. A lessee shall determine the revised lease payments on the basis of the revised lease term, and recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset for the following reasons –

- a change in the assessment of extension (as in this case) reflects the lessee's determination that it has acquired more or less of the right to use the underlying asset. Consequently, that change is appropriately reflected as an adjustment to the cost of the right-of-use asset.
- a change in the estimate of the future lease payments is a revision to the initial estimate of the cost of the right-of-use asset, which should be accounted for in the same manner as the initial estimated cost.

The right-of-use asset from 1 January 20X4 to 31 December 20X6 is –

Date (31 Dec)	Balance bf (CU)	Depreciation (CU)	Balance cf (CU)
20X4	17,500	(5,833)	11,667
20X5	11,667	(5,833)	5,834
20X6	5,834	(5,834)	–

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20X4

At the beginning of the renewal period on 1 January 20X4, Entity A recognises an increase in right-of-use asset and a corresponding lease liability –

➢ Right-of-use asset	CU 15,500*	
Lease liability		CU 15,500*

*There is a balance of CU 2,000 as penalty for terminating the lease, which is not payable. Therefore, only CU 15,500 (17,500 – 2,000) is to be recognised.

At the end of the year on 31 December 20X4, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 1,575	
Lease liability		CU 1,575

- *Lease payment*

Lease liability	CU 6,000	
Cash		CU 6,000

- *Variable lease payment*

Lease expense	CU 1,600 (80,000 x 2%)	
Cash		CU 1,600

- *Depreciation of the right-of-use asset*

Depreciation	CU 5,833	
Accumulated depreciation		CU 5,833

- *Recognition in profit or loss*

Profit or loss	CU 9,008	
Interest expense		CU 1,575
Lease expense		CU 1,600
Depreciation		CU 5,833

20X5

At the end of the year on 31 December 20X5, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 1,177	
Lease liability		CU 1,177

- *Lease payment*

Lease liability	CU 6,000	
Cash		CU 6,000

- *Variable lease payment*

Lease expense	CU 1,800 (90,000 x 2%)	
Cash		CU 1,800

- *Depreciation of the right-of-use asset*

Depreciation	CU 5,833	
Accumulated depreciation		CU 5,833

- *Recognition in profit or loss*

Profit or loss	CU 8,810	
Interest expense		CU 1,177
Lease expense		CU 1,800
Depreciation		CU 5,833

20X6

At the end of the year on 31 December 20X6, Entity A recognises –

- *Interest on the liability to make lease payment*

Interest expense	CU 748	
Lease liability		CU 748

- *Lease payment*

Lease liability	CU 9,000	
Cash		CU 9,000

- *Variable lease payment*

Lease expense	CU 2,000 (100,000 x 2%)	
Cash		CU 2,000

- *Depreciation of the right-of-use asset*

Depreciation	CU 5,834	
Accumulated depreciation		CU 5,834

- *Recognition in profit or loss*

Profit or loss	CU 8,582	
Interest expense		CU 748
Lease expense		CU 2,000
Depreciation		CU 5,834

Presentation

Balance Sheet (Extract)

	20X1	20X2	20X3	20X4	20X5
Assets					
Right-of-use asset	18,000	9,000	2,000	11,667	5,834
Liabilities					
Lease liability	10,478	6,421	2,000	13,075	8,252

Statement of Profit and Loss and Other Comprehensive Income (Extract)

	20X1	20X2	20X3	20X4	20X5	20X6
Expenses						
Finance costs (interest expense)	1,278	943	579	1,575	1,177	748
Depreciation charge	9,000	9,000	7,000	5,833	5,833	5,834
Variable lease expense	1,000	1,200	1,500	1,600	1,800	2,000

Statement of Cash Flows (Extract)

	20X1	20X2	20X3	20X4	20X5	20X6
Operating activities						
Interest portion of lease liability	1,278	943	579	1,575	1,177	748
Variable lease expense	1,000	1,200	1,500	1,600	1,800	2,000
Financing activities						
Principal portion of lease liability	3,722	4,057	4,421	4,425	4,823	8,252

Disclosures

	20X1	20X2	20X3	20X4	20X5	20X6
Depreciation charge	9,000	9,000	7,000	5,833	5,833	5,834
Interest expense	1,278	943	579	1,575	1,177	748
Variable lease expense	1,000	1,200	1,500	1,600	1,800	2,000
Total cash outflow for lease	5,000	5,000	5,000	6,000	6,000	9,000
Carrying amount of right-of-use asset at the end of the reporting period	18,000	9,000	2,000	11,667	5,834	–

Entity B (Lessor)

At the commencement date –

- Entity B considers all relevant facts and circumstances that create an economic incentive for Entity A to exercise the option, therefore, Entity B determines the lease term is 6 years.
- Entity B classifies the leased machine as finance lease, since the lease term transfers substantially all the risks and rewards incidental to ownership of the underlying asset.
- The carrying amount of the machine is CU 31,000 and its fair value is CU 33,100.
- Entity B incurs initial direct costs of CU 2,000.
- Entity B uses the interest rate implicit in the lease @ 10% p.a. to measure the net investment in the lease.

At the commencement date, the present value of annual lease receipts is –

Date (31 Dec)	Cash Inflow (CU)	Discount rate @ 10% p.a.	Present value (CU)
20X1	5,000	0.909	4,540
20X2	5,000	0.826	4,130
20X3	5,000	0.751	3,750
20X4	5,000	0.683	3,410
20X5	5,000	0.621	3,100
20X6	8,000*	0.564	4,510
	zNet Investment in the lease		**23,440**

* includes CU 3,000 as guaranteed residual value.

At the inception date, the present value of the lease receipts amounts to at least substantially all of the fair value of the underlying asset. Here, the present value of the lease receipts is CU 33,540 (CU 10,100 + CU 23,440) which is more than the fair value (CU 33,100). Therefore, the condition is satisfied.

The lease receivable from 31 December 20X1 to 31 December 20X3 is –

Date (31 Dec)	Balance bf	Finance income @ 10% p.a.	Receipt	Balance cf
20X1	23,440	2,344	(5,000)	20,784
20X2	20,784	2,078	(5,000)	17,862
20X3	17,862	1,786	(5,000)*	14,648

*As the contract is expected to be renewed, the termination penalty does not arise.

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20X1

At the commencement date on 1 January 20X1, Entity B recognises the machine held under a finance lease in its Balance Sheet and presents that as a receivable at an amount equal to the net investment in the lease –

➢ Cash (amount received at the commencement date)	CU 10,100	
Lease receivable (net investment in the lease)	CU 23,440	
Property, plant and equipment		CU 31,000
Cash (initial direct costs)		CU 2,000
Gain on lease (balancing figure)		CU 540

At the end of the year on 31 December 20X1, Entity B recognises –

➢ *Finance income on lease receivable*		
Lease receivable	CU 2,344	
Finance income		CU 2,344
➢ *Receipt of lease receivable*		
Cash	CU 5,000	
Lease receivable		CU 5,000
➢ *Variable lease income*		
Cash	CU 1,000 (50,000 x 2%)	
Lease income		CU 1,000
➢ *Recognition in profit or loss*		
Finance income	CU 2,344	
Lease income	CU 1,000	
Profit or loss		CU 3,344

20X2

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

- *Finance income on lease receivable*

Lease receivable	CU 2,078	
Finance income		CU 2,078

- *Receipt of lease receivable*

Cash	CU 5,000	
Lease receivable		CU 5,000

- *Variable lease income*

Cash	CU 1,200 (60,000 x 2%)	
Lease income		CU 1,200

- *Recognition in profit or loss*

Finance income	CU 2,078	
Lease income	CU 1,200	
Profit or loss		CU 3,278

20X3

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

- *Finance income on lease receivable*

Lease receivable	CU 1,786	
Finance income		CU 1,786

- *Receipt of lease receivable*

Cash	CU 5,000	
Lease receivable		CU 5,000

- *Variable lease income*

Cash	CU 1,500 (75,000 x 2%)	
Lease income		CU 1,500

- *Recognition in profit or loss*

Finance income	CU 1,786	
Lease income	CU 1,500	
Profit or loss		CU 3,286

At the beginning of the year on 1 January 20X4, the present value of the lease receipts is –

Date (31 Dec)	Cash Inflow (CU)	Discount rate @ 10% p.a.	Present value (CU)
20X4	6,000	0.909	5,454
20X5	6,000	0.826	4,956
20X6	9,000*	0.751	6,760
	Net Investment in the lease		**17,170**

* [CU 6,000 + CU 3,000)

The lease receivable has a balance of CU 14,648. Therefore, only CU 2,522 (17,170 – 14,648) is to be created as lease receivable.

The lease receivable from 31 December 20X4 to 31 December 20X6 is –

Date (31 Dec)	Balance bf	Finance income @ 10% p.a.	Receipt	Balance cf
20X4	17,170	1,717	6,000	12,887
20X5	12,887	1,288	6,000	8,175
20X6	8,175	825 (balancing figure)	9,000*	–

20X4

At the beginning of the year on 1 January 20X4, Entity B recognises the required balance of lease receivable at an amount equal to the net investment in the lease –

➢ Lease receivable (CU 17,170 – CU 14,648)	CU 2,522	
Profit or loss		CU 2,522

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

➢ *Finance income on lease receivable*		
Lease receivable	CU 1,717	
Finance income		CU 1,717
➢ *Receipt of lease receivable*		
Cash	CU 6,000	
Lease receivable		CU 6,000
➢ *Variable lease income*		
Cash	CU 1,600 (80,000 x 2%)	
Lease income		CU 1,600
➢ *Recognition in profit or loss*		
Finance income	CU 1,717	
Lease income	CU 1,600	
Profit or loss		CU 3,317

20X5

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

- *Finance income on lease receivable*

Lease receivable	CU 1,288	
Finance income		CU 1,288

- *Receipt of lease receivable*

Cash	CU 6,000	
Lease receivable		CU 6,000

- *Variable lease income*

Cash	CU 1,800 (90,000 x 2%)	
Lease income		CU 1,800

- *Recognition in profit or loss*

Finance income	CU 1,288	
Lease income	CU 1,800	
Profit or loss		CU 3,088

20X6

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

- *Finance income on lease receivable*

Lease receivable	CU 825	
Finance income		CU 825

- *Receipt of lease receivable*

Cash	CU 9,000	
Lease receivable		CU 9,000

- *Variable lease income*

Cash	CU 2,000 (100,000 x 2%)	
Lease income		CU 2,000

- *Recognition in profit or loss*

Finance income	CU 825	
Lease income	CU 2,000	
Profit or loss		CU 2,825

Disclosure

	20X1	20X2	20X3	20X4	20X5	20X6
Gain	540	–	–	–	–	–
Finance income	2,344	2,078	1,786	1,717	1,288	825
Variable lease income	1,000	1,200	1,500	1,600	1,800	2,000