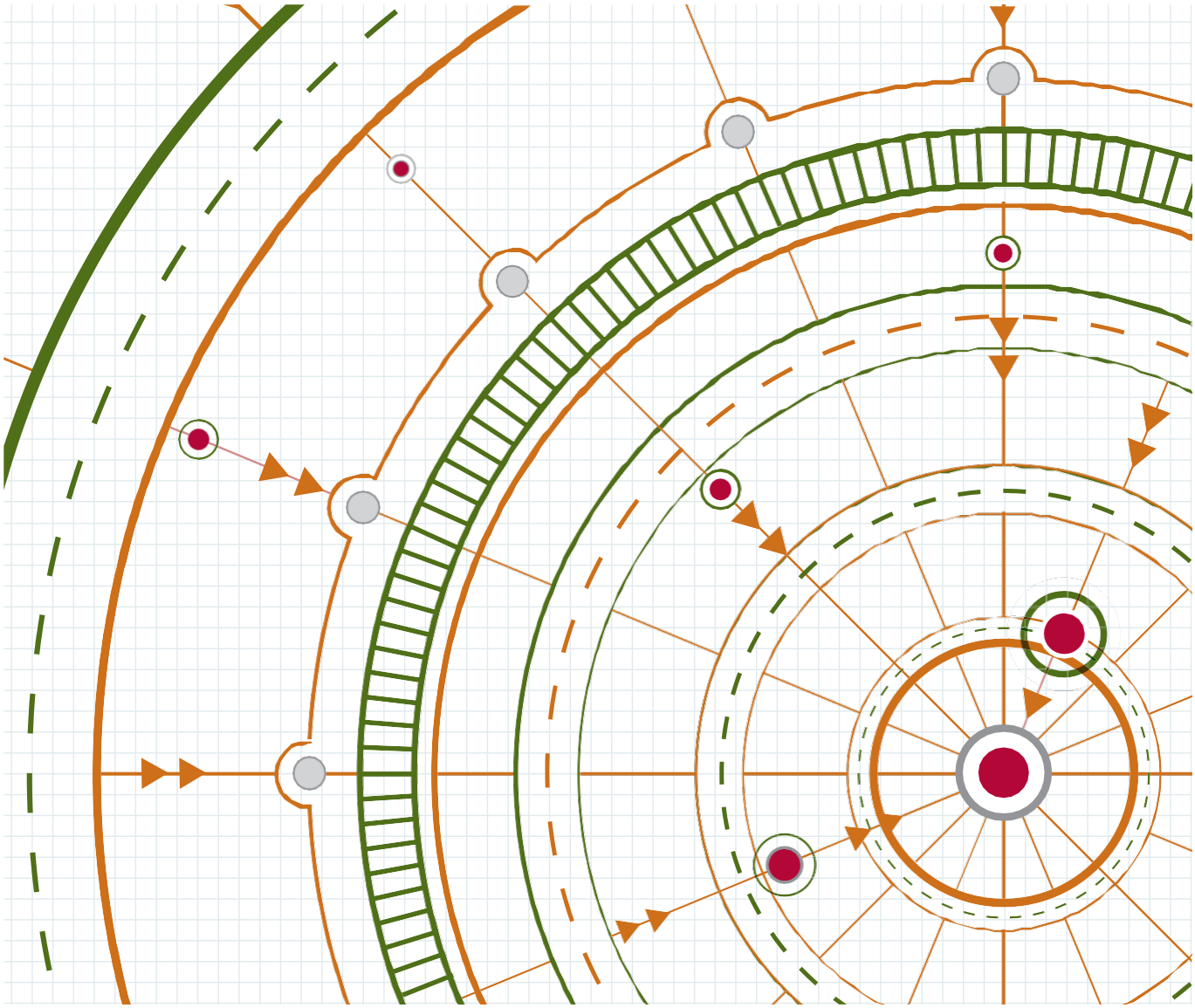
IFRS for SMEs® Standard (2015) + Q&As

IFRS® Foundation—Supporting Material for the *IFRS for SMEs* Standard

Module 20—Leases



IFRS®

IFRS® Foundation Supporting Material for the *IFRS for SMEs*® Standard

including the full text of
Section 20 *Leases*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and case studies

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Module 20—Leases

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015.
This module has been prepared by IFRS Foundation education staff.
The contents of Section 20 *Leases* of the *IFRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 20. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*® Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the accounting of leases applying Section 20 *Leases* of the *IFRS for SMEs* Standard. It introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. The module identifies the significant judgements required in accounting for leases. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide a practical opportunity to apply the requirements on accounting for leases in the *IFRS for SMEs* Standard.

Module 20—Leases

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

- identify lease arrangements that qualify for recognition under this Standard;
- distinguish between finance leases and operating leases;
- recognise and measure the rights and obligations that arise from finance leases in the financial statements of the lessee and those of the lessor;
- measure the recognised assets and liabilities after their initial recognition in the financial statements of the lessee and those of the lessor;
- account for lease payments that arise from operating leases in the financial statements of the lessee and those of the lessor;
- present and disclose leases in the financial statements of the lessee and those of the lessor; and
- demonstrate an understanding of the significant judgements that are required in accounting for leases.

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board's main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the IFRS for SMEs Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* These appendices provide non-mandatory guidance.

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as 'questions and answers' (Q&As). These Q&As provide non-mandatory, timely guidance on

specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The objective of Section 20 is to prescribe the accounting and disclosure requirements for leases in the financial statements of lessees and lessors.

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or a series of payments the right to use an asset for an agreed period of time.

Lease classification

A primary issue in accounting for leases is the classification of the lease as either a finance lease or an operating lease. A finance lease transfers substantially all the risks and rewards incidental to ownership. An operating lease does not.

Finance leases

A lessee accounts for a finance lease as a purchase of an asset on credit (ie at the commencement of the lease the lessee recognises the rights and obligations arising from the lease at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments). Conversely, a lessor (including a manufacturer or dealer lessor) that has previously recognised the asset accounts for a finance lease as the sale of an asset on credit. The future amounts receivable under the terms of lease are recognised by any lessor as a receivable.

After initial recognition of a finance lease the lessee accounts for the leased asset in accordance with other sections of the *IFRS for SMEs* Standard (eg Section 17 *Property, Plant and Equipment*). The lessee apportions the minimum lease payments between finance charge (interest expense) and repayment of the finance lease liability using the effective interest method. The lessor apportions the minimum lease payments between finance income on the receivable and repayment of the finance lease receivable using the effective interest method.

Operating leases

The lessee and the lessor recognise lease payments under operating leases in profit or loss on the straight-line basis over the lease term unless specific exceptions apply (eg another systematic basis is representative of the time pattern of the user's benefit).

Sale and leaseback transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends on the type of lease (ie finance lease or operating lease).

Module 20—Leases

What has changed since the 2009 *IFRS for SMEs* Standard

The following are the changes made to Section 17 by the 2015 Amendments:

- Modification to include leases with an interest rate variation clause that is linked to market interest rates within the scope of Section 20 instead of Section 12 (see paragraph 20.1(e)).
- Clarification that only some outsourcing arrangements, telecommunication contracts that provide rights to capacity and take-or-pay contracts are, in substance, leases (see paragraph 20.3).

In addition, this module reproduces other editorial changes.

Module 20—Leases

REQUIREMENTS AND EXAMPLES

Scope of this section

20.1 This section covers accounting for all **leases** other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see Section 34 *Specialised Activities*);

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights (see Section 18 *Intangible Assets other than Goodwill*);

(c) **measurement** of property held by lessees that is accounted for as **investment property** and measurement of investment property provided by lessors under **operating leases** (see Section 16 *Investment Property*);

(d) measurement of **biological assets** held by lessees under **finance leases** and biological assets provided by lessors under operating leases (see Section 34);

(e) leases that could lead to a loss to the lessor or the lessee as a result of contractual terms that are unrelated to changes in the price of the leased **asset**, changes in foreign exchange rates, changes in lease payments based on variable market interest rates, or a default by one of the counterparties (see paragraph 12.3(f)); and

(f) operating leases that are onerous.

Notes

A lease is an agreement whereby the lessor conveys to the lessee in return for payment or a series of payments the right to use an asset for an agreed period of time (see Glossary).

Operating leases that are onerous are outside the scope of Section 20. However, they are dealt with by Section 21 (see paragraph 21.1(a)).

Examples – scope of Section 20

Ex 1 **An entity owns a property to earn rentals and for capital appreciation. It enters into an agreement whereby it grants an independent third party the right to use the building for 10 years in return for payment of CU1,000[1] per year. The independent third party (lessee) intends using the building for its head office. The arrangement is not considered onerous for either party.**

The arrangement is a lease—it is an agreement whereby the lessor (the entity) conveys to the lessee (the independent third party) in return for payment or a series of payments (payment of CU1,000 per year) the right to use an asset (the building) for an agreed period of time (10 years).

Lessor's perspective

The property is an investment property (ie held to earn rentals and for capital appreciation, see Section 16 *Investment Property* paragraph 16.2). The measurement of the investment property is outside the scope of Section 20 (see paragraph 20.1(c)). The investment property is accounted for in accordance with Section 16 *Investment Property*. However, the lease income is accounted for in accordance with Section 20. The disclosures required by Section 20 must also be presented.

[1] In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

Lessee's perspective

The lease is accounted for in accordance with Section 20.

Ex 2 **An entity (as the lessee) leases a building under an operating lease from an independent third party (the owner of the property). Furthermore, the entity (as the lessor) subleases the building under operating leases to various independent third parties who occupy the property. The entity profits from its leasehold interest in the building by charging a higher amount to its tenants than it is charged by its landlord. In accordance with paragraph 16.3 the entity elected to account for its interest in the building as an investment property. The entity can measure reliably the fair value of the property interest without undue cost or effort on an ongoing basis. The arrangement is not considered onerous for either party.**

The arrangement is a lease—it is an agreement whereby the lessor conveys to the lessee (the entity) in return for payment or a series of payments the right to use an asset for an agreed period of time.

The entity

The entity elected to account for its interest in the building as an investment property. Therefore, in spite of the classification of the arrangement, it accounts for its interest in the building in accordance with Section 16 (see paragraph 16.6)—ie recognise an asset (investment property) and a liability (obligation to make lease payments)—rather than Section 20 (see paragraph 20.1(c)).

Note: If the entity cannot measure the fair value of its interest in the property reliably without undue cost or effort it is prohibited from electing to account for its leasehold interest in the building as an item of investment property see Section 16 *Investment Property* paragraph 16.4). In those circumstances the requirements in Section 20 pertaining to operating leases would apply.

The entity's lessor (the owner of the property)

The property is an investment property. The measurement of the investment property is outside the scope of Section 20 (see paragraph 20.1(c)). The investment property is accounted for in accordance with Section 16 *Investment Property*. However, the lease income is accounted for in accordance with Section 20. The disclosures required by Section 20 must also be presented.

The entity's lessees (the occupants of the property)

The entity's lessees would account for the lease in accordance with Section 20.

Ex 3 **An entity created a motion picture film. In return for a series of royalty payments the entity licenses various cinema operators worldwide to show the film in cinemas operated by the licensees for a 12-month period.**

The arrangement is a lease—it is an agreement whereby the lessor (the entity) conveys to the lessee (the cinema operators worldwide) in return for payment or a series of payments (the royalty payments) the right to use an asset for an agreed period of time (the 12-month period).

However, the licensing arrangement is not accounted for in accordance with Section 20. It is accounted for in accordance with Section 18 *Intangible Assets other than Goodwill* (see paragraph 20.1(b)).

20.2 This section applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This section does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Example – lease with other services

Ex 4 **An entity leases a photocopier from an independent third party under an operating lease. As part of that agreement the lessor agrees to provide maintenance services to the lessee in respect of the photocopier.**

The arrangement contains a lease—it is an agreement whereby the lessor (the independent third party) conveys to the lessee the right to use an asset for an agreed period of time, in addition to the provision of services.

Lessee's and Lessor's perspective

Even though the lessor also agrees to provide maintenance services, 20.2 still requires an arrangement that contains a lease be accounted for under Section 20.

20.3 Some arrangements, such as some outsourcing arrangements, telecommunication contracts that provide rights to capacity and take-or-pay contracts, do not take the legal form of a lease but convey rights to use assets in return for payments. Such arrangements are in substance leases of assets and they shall be accounted for under this section.

Example – an arrangement that contains a lease

Ex 5 **Company A enters into an arrangement to supply gas to Company B. For this purpose, Company A designs and builds a facility adjacent to Company B to produce the needed gas. Gas cannot be provided to Company B from another facility, and no one else does or can benefit from its use. In terms of the agreement, Company B determines how much gas is supplied each month based on its needs. It pays Company A a fixed amount each month, in addition to a variable amount proportional to monthly supply.**

The arrangement contains a lease within the scope of Section 20 — it is an agreement that conveys the right for Company B to use the facility in return for payments.

Company B has obtained the right to use the facility because it has been built only to meet its needs and it has control over the quality of gas produced. It should therefore be accounted for as a lease.

Classification of leases

20.4 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Notes

To be classified as a finance lease, the lease must transfer substantially all the risks and rewards incidental to ownership. All other leases are operating leases.

Risks include the possibilities of losses from idle capacity or technological obsolescence, and of variations in return because of changing economic conditions (including changes in the value of any residual interest).

Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value of any residual interest.

'Substantially all' is a high hurdle and the finance lease classification is typically not appropriate in cases in which the lessor retains more than significant risks and rewards of ownership.

In most cases the same classification (finance lease or operating lease) is appropriate for both the lessee and the lessor. However, in some cases different classifications are appropriate.

Example – finance lease classification

Ex 6 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of five years and nil residual value.**

On 1 January 20X1 (the inception of the lease) the fair value (cash cost) of the machine is CU100,000.

On 31 December for each of the first four years of the lease term the lessee is required to pay the lessor CU23,000. At the end of the lease term, ownership of the machine passes to the lessee upon payment of the final lease payment of CU23,539.

The interest rate implicit in the lease is 5% per year. This rate approximates the lessee's incremental borrowing rate.

The arrangement is a finance lease. On 1 January 20X1 the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee now owns the machine. The lessee is the party that benefits from the use of the leased asset during its entire expected economic life.

Examples – operating lease classification

Ex 7 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of farmland with a fair value (cash cost) of CU100,000.**

The lessee is required to pay the lessor CU5,000 per year.

The arrangement is an operating lease. The lease does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee (eg gains and losses in the fair value of the farmland accrue to the benefit of the lessor during and

after the lease agreement). The lessee merely has the temporary right of use of the farmland for a small part (five years) of the indefinite economic life of the farmland.

Ex 8 **On 1 January 20X1 an entity entered, as lessee, into a five-day non-cancellable lease of a motor vehicle that has an economic life of five years and nil residual value.**

On 1 January 20X1 (the inception of the lease), the fair value (cash cost) of the motor vehicle is CU100,000.

The lessor charges the lessee CU120 per day for the use of the motor vehicle. At the end of the lease term the lessee returns the motor vehicle to the lessor.

The arrangement is an operating lease. The lease does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee. The lessee merely obtains the right to use the lessor's motor vehicle for a small part (five days) of the economic life (five years) of the vehicle.

Example – multiple parties to a lease classification

Ex 9 **A tripartite lease agreement whereby the lessor (Entity A) transfers substantially all the risks and rewards of ownership to two unrelated parties—the lessee (Entity B) obtains the right of use of the leased asset for a specified period and the other party (Entity C) contracts to acquire the leased asset from the lessor (Entity A) at the end of the lease term at a fixed price.**

In this case, the lessor (Entity A) and the lessee (Entity B) would classify the lease as a finance lease and an operating lease respectively.

The third party (Entity C) has a firm commitment to acquire the leased asset at the end of the lease term.

20.5 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction instead of the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the **fair value** at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the **present value** of the **minimum lease payments** amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Notes

Paragraph 20.5 sets out situations that would normally lead to a lease being classified as a finance lease. The paragraph considers that the situations described in (a) to (e) may exist individually or in combination. These situations should be considered

together with paragraph 20.4 when assessing whether the lease transfers substantially all the risks and rewards incidental to ownership.

Transfer of ownership - paragraphs 20.5(a) and 20.5(b)

If legal ownership of the asset transfers to the lessee by the end of the lease term, that would normally lead to a lease being classified as a finance lease.

If a lease contains a purchase option that is reasonably certain to be exercised by the lessee, that would indicate legal ownership of the asset is expected to pass to the lessee. Therefore, a lease with such an option would normally be a finance lease. The assessment of whether it is reasonably certain that a lessee would exercise the purchase option is based on facts and circumstance at the inception of the lease. It is not determined based on the intention of the lessee.

Major part of the economic life - paragraph 20.5(c)

As indicated in paragraph 20.5(c), if the lease term is for the major part of the economic life of the leased asset, then the lease would normally be classified as a finance lease. An entity uses judgement to assess what is considered to be the major part of an asset's economic life.

Economic life is not defined in the *IFRS for SMEs* Standard, but it is generally understood to mean either:

- the period over which an asset is expected to be economically usable by one or more users; or
- the number of production or similar units expected to be obtained from the asset by one or more users.

Present value of minimum lease payments amounts to substantially all of the fair value - paragraph 20.5(d)

An entity uses judgement to assess what is considered to be substantially all of the fair value of the leased asset.

Although the term *inception of the lease* is not defined in the *IFRS for SMEs* Standard, using the substance over form concept in Section 2 (see paragraph 2.8), the inception of the lease would be the date the lease agreement is entered into, whether in writing or otherwise.

The Glossary of the *IFRS for SMEs* Standard defines **minimum lease payments** as the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
- for a lessor, any residual value guaranteed to the lessor by:
  - (i) the lessee;
  - (ii) a party related to the lessee; or
  - (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

The definition in the glossary adds: However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date

the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Assets of specialised nature - paragraph 20.5(e)

A leased asset that is so specialised in nature that only the lessee can use it without major modification would normally lead to the lessor demanding lease terms that protect it from the return of the asset before the lessor has recovered substantially all of the value of the asset. Thus, these types of contracts typically satisfy one of the indicators contained in (a) to (d) above or include some other term to reduce the lessors risk. This indicator does not in isolation require the lease to be treated as a finance lease, however it does require careful examination of the contract terms and typically leads to the lease being classified as a finance lease.

An example would be a building designed and built for the lessee that meets its highly specific and specialised needs. An example of a lease term that may satisfy this condition is a lease with significantly higher than market lease payments in its initial term, with a renewable option at a lease payment that will be significantly lower than market. Another example would be a lease agreement that imposes a significant penalty if the lessee does not renew the contract.

Lease of land

Paragraph 20.5 emphasises that lease classification depends on substance rather than form. When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 20.1-20.8. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life. This means that typically even a relatively long lease of land would not result in the lease been classified as a finance lease because there has not been a transfer of substantially all the risks and rewards incidental to ownership. Thus, for example, a 50-year lease of land and buildings may result in the land been considered an operating lease and the building been treated as a finance lease.

However, these need not always be the case. In considering whether a lease of property is a finance lease, the parties will consider what the expected value of the land will be when it is released from the lease and discount that value back to date of the lease been signed. The longer the lease term, the more likely it will be that, on a discounted value basis, at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset (20.5(d)). For example, in a 999-year lease of land and buildings the significant risks and rewards associated with the land during the lease term would have been transferred to the lessee despite there being no transfer of title. Accounting for the land element as a finance lease in such circumstances would be consistent with the economic position of the lessee.

Examples – finance lease classification

Ex 10 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of 10 years, at the end of which it is expected to have no value.**

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

On 31 December for each of the first four years of the lease term the lessee is required to pay the lessor CU23,000. At the end of the lease term ownership of the machine passes to the lessee upon payment of the final lease payment of CU23,539.

The interest rate implicit in the lease is 5% per year, which approximates the lessee's incremental borrowing rate.

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease.
The finance lease classification is evidenced by:

- the lease transfers ownership of the asset to the lessee by the end of the lease term (see paragraph 20.5(a)); and
- at the inception of the lease the present value of the minimum lease payments amounts to all of the fair value of the leased asset—see table below calculating the present value of the minimum lease payments as CU100,000, ie substantially all of the fair value of the leased asset (see paragraph 20.5(d)).

Present value of the minimum lease payments table:

Year	*Discount factor*	*Payment*	*Present value of payment*
20X1	1.050[(a)]	(23,000)	21,905[(b)]
20X2	1.103	(23,000)	20,862
20X3	1.158	(23,000)	19,868
20X4	1.216	(23,000)	18,922
20X5	1.276	(23,539)	18,443
Total			**100,000**

(a) The discount factor in the first year (20X1) is computed as (1+0.05); second year $(1+0.05)^2$; third year $(1+0.05)^3$ etc.
Alternatively, the discount factor could be computed as follows: 20X1: 1.050; 20X2: 1.050 x 1.050=1.103; 20X3: 1.050 x 1.103 = 1.158; etc

(b) The present value of payment for 20X1: 23,000 ÷ 1.050 = CU 21,905

Ex 11 **The facts are the same as in Example 10. However, in this example, ownership of the machine does not automatically pass to the lessee at the end of the lease. Instead, the lease provides the lessee with an option to acquire the machine from the lessor on 1 January 20X6 for CU1.**

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease—at the inception of the lease the lessee is expected to exercise its option to buy the machine for CU1 on 1 January 20X6. The finance lease classification is evidenced by:

- the bargain purchase option at the end of the lease term, ie the option to purchase the machine for CU1 when it has five years' remaining useful life (see paragraph 20.5(b)); and
- at the inception of the lease the present value of the minimum lease payments amounts to all of the fair value of the leased asset—see table in example 10 calculating the present value of the minimum lease payments as CU100,000, ie substantially all of the fair value of the leased asset (see paragraph 20.5(d)).

Ex 12 **The facts are the same as in Example 10. However, in this example, the economic life of the machine is five years and ownership of the machine does not pass to the lessee at the end of the lease.**

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease—the lessee benefits from the use of the asset for its entire economic life. The finance lease classification is evidenced by the following:

- the lease term is for the entire (ie more than a major part of) economic life of the machine (see paragraph 20.5(c)); and
- at the inception of the lease the present value of the minimum lease payments amounts to all of the fair value of the leased asset—see table in example 10 calculating the present value of the minimum lease payments as CU100,000, ie substantially all of the fair value of the leased asset (see paragraph 20.5(d)).

20.6 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) **gains** or losses from the fluctuation in the **residual value** of the leased asset accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Notes

Paragraph 20.5 sets out indicators that would normally lead to a lease being classified as a finance lease. Paragraph 20.6 provides additional indicators that could indicate a finance lease. The indicators in paragraph 20.6 may be considered in combination with one another, or in combination with the situations described in 20.5.

Examples – finance lease classification

Ex 13 **On 1 January 20X1 an entity enters into a lease for the use of a machine that has an economic life of five years and nil residual value. The lessee is required to pay the lessor CU23,000 per year.**

The lessee can terminate the lease on 1 January of any year. However, termination obliges the lessee to pay the lessor a termination penalty. The amount of the penalty depends on the date of termination as follows:

Termination date	*Penalty*
	CU
1 January 20X2	82,000
1 January 20X3	63,100
1 January 20X4	43,255
1 January 20X5	22,418
After 1 January 20X5	nil

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

The lessee's incremental borrowing rate is 5% per year.

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease.

Although the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee (see paragraph 20.6(a)). The amount of the penalty approximates the present value of the remaining lease payments at each termination date (see table on exit costs of the finance lease below).

Finance lease obligation amortisation table assuming the lease is cancelled on 1 January 20X6:

Year	*Lease liability at 1 January*	*Finance cost*	*Payment*	*Lease liability at 31 December*
20X1	100,000	5,000	(23,000)	82,000 [(a)]
20X2	82,000	4,100	(23,000)	63,100 [(a)]
20X3	63,100	3,155	(23,000)	43,255 [(a)]
20X4	43,255	2,163	(23,000)	22,418 [(a)]
20X5	22,418	1,121	(23,539)	nil

[(a)] Penalty payable on next day (1 January) if the lessee cancels the lease. The penalty equals the capital amount of the outstanding finance lease obligation.

Ex 14 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of 10 years and nil residual value.**

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

On 31 December for each of the five years of the lease term the lessee is required to pay the lessor CU20,000.

However, in accordance with the lease agreement, the lessee has an option to continue the lease for a further five years at a lease payment of CU3,958 per year which is considerably below market value.

The lessee's incremental borrowing rate is 5% per year.

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease. The finance lease classification is evidenced by the following:

- although the present value of the minimum lease payments for the first five years of the lease term do not amounts to all CU100,000 of the fair value of the leased asset (ie CU 86,572), the lessee has the ability to continue the lease for a secondary period at an amount that is substantially lower than market rent term (see paragraph 20.6(c)); and
- at the inception of the lease the present value of the minimum lease payments amounts to all CU100,000 of the fair value of the leased asset over the 10 years ie including the secondary period—see the table below (see paragraph 20.5(d)).

Present value of the minimum lease payments table:

Year	*Discount factor*	*Payment*	*Present value of payment*
20X1	1.05	(20,000)	19,048
20X2	1.103	(20,000)	18,132
20X3	1.158	(20,000)	17,271
20X4	1.216	(20,000)	16,447
20X5	1.276	(20,000)	15,674
sub-total			86,572
20X6	1.34	(3,958)	2,954
20X7	1.41	(3,958)	2,813
20X8	1.48	(3,958)	2,680
20X9	1.55	(3,958)	2,551
20X10	1.63	(3,958)	2,430
Total			**100,000**

Ex 15 **On 1 January 20X1 an entity entered, as lessee, into a three-year non-cancellable lease of a motor vehicle that has an economic life of seven years.**

At the inception of the lease, the fair value (cash cost) of the motor vehicle is CU100,000.

On 31 December 20X1, 20X2 and 20X3 the lessee is required to pay the lessor CU25,000. The lessor is required to sell the motor vehicle to an independent third party at the end of the lease term. If the motor vehicle is sold for less than CU36,950 the lessee will pay the shortfall to the lessor. Conversely, if the motor vehicle is sold for more than CU36,950 the lessee will receive the excess from the lessor in the form of rental rebate.

The lessee's incremental borrowing rate is 5% per year.

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease.
The finance lease classification is evidenced by the following:

- gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee, ie as the case may be, in the form of the rental rebate or the payment in fulfilment of the guarantee obligation (see paragraph 20.6(b)); and
- at the inception of the lease the present value of the minimum lease payments (including the guaranteed residual value) amounts to all of the fair value of the leased asset – see table below calculating the present value of the minimum lease payment as CU 100,000 (see paragraph 20.5(d)).

Present value of the minimum lease payments table:

Year	*Discount factor*	*Payment*		*Present value of payment*
20X1	1.050	(25,000)		23,810
20X2	1.103	(25,000)		22,675
20X3	1.158	(25,000)		21,600
20X3	1.158	(36,950)	(a)	31,915
				100,000

Finance lease obligation amortisation table:

Year	*Lease liability at 1 January*	*Finance cost*	*Payment*	*Lease liability at 31 December*	
20X1	100,000	5,000	(25,000)	80,000	
20X2	80,000	4,000	(25,000)	59,000	
20X3	59,000	2,950	(25,000)	36,950	(a)

(a) Guaranteed residual value.

20.7 The examples and indicators in paragraphs 20.5 and 20.6 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset is transferred to the lessee at the end of the lease for a variable payment equal to the asset's then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all risks and rewards incidental to ownership.

Notes

Paragraph 20.5 and 20.6 set out indicators that a lease is a finance lease. However, in some arrangements these indicators may not be conclusive. In those circumstances, an entity should use judgement to assess whether the lease transfers substantially all the risks and rewards incidental to ownership (see paragraph 20.4).

The term contingent rent is not defined in the *IFRS for SMEs* Standard but it is generally understood to mean rent that varies depending on a certain condition (eg percentage of future sales, amount of future use, future price indices etc).

20.8 Lease classification is made at the inception of the lease and is not changed during the term of the lease unless the lessee and the lessor agree to change the provisions of the lease (other than simply by renewing the lease), in which case the lease classification shall be re-evaluated.

Notes

Classification of a lease is made at inception and is not subsequently changed during the lease term. However, if the lessee and lessor agree to change the provisions of the lease, the lease classification is re-evaluated. The revised agreement is regarded as a new agreement over its term. Therefore, in such circumstances, an operating lease could become a finance lease or vice-versa. A renewal of a contract is for accounting purposes a new contract, and is assessed as a new contract.

Examples – classification not re-evaluated

Ex 16 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a barge that has an economic life of 11 years and nil residual value.**

At the inception of the lease, the fair value (cash cost) of the barge is CU100,000.

On 31 December for each year of the lease term the lessee is required to pay the lessor CU15,000.

The lessee has an option to acquire the barge from the lessor on 31 December 20X5 for CU44,744 (at the inception of the lease CU44,744 is the expected market value of the machine on 31 December 20X5).

The lessee's incremental borrowing rate is 5% per year.

In 20X2 the expected market value of the barge on 31 December 20X5 increased to CU120,000.

At the inception of the lease the lessee and the lessor classified the arrangement as an operating lease. At that time, the lease did not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee. If on 31 December 20X5 the fair value of the barge is significantly less than CU44,744, the lessee will probably not exercise the option (ie a significant risk (the residual value risk) remains with the lessor).

In 20X2 it became reasonably certain that the lessee would exercise the option to acquire the barge at the end of the lease term, because the strike price CU44,744 became considerably lower than the expected market value of the barge of CU120,000. The 'bargain purchase option' indicates that significantly all the risks and rewards of ownership of the barge have now been transferred from the lessor to the lessee.

However, the lessor and the lessee do not reclassify the lease because there has been no change to the provisions of the lease.

Ex 17 **The facts are the same as in Example 16. However, in this example, on 1 January 20X1 the market value of the barge at the end of the lease was expected to be CU100,000.**

In 20X2 the expected market value of the barge on 31 December 20X5 fell to CU20,000.

At the inception of the lease the lessee and the lessor classified the arrangement as a finance lease. At that time, the lease transferred substantially all the risks and rewards incidental to ownership from the lessor to the lessee. The present value of the minimum lease payments (including the CU44,744 bargain purchase option) exceeded the fair value of the leased asset (see paragraph 20.5(d)) and, given the strike price of the option held by the lessee to purchase the barge at the end of the lease term, the lessee is expected to exercise the option to purchase the barge.

In 20X2 it became reasonably certain that the lessee would not exercise the option to acquire the barge at the end of the lease term, as the strike price CU44,744 is much higher than the expected market value of the barge. The lessee will likely return the barge to the lessor at the end of the lease term (ie it is now apparent that substantially all the risks and rewards of ownership of the barge have not passed from the lessor to the lessee). However, the lessor and the lessee do not reclassify the lease because there has been no change to the provisions of the lease (ie they continue to account for the finance lease. However, the lessee needs to decide whether to accelerate depreciation or impair the barge.

Ex 18 **The facts are the same as in Example 16. However, in this example, on 31 December 20X3 the remaining expected economic life of the barge was revised to two years.**

At the inception of the lease the lessee and the lessor classified the arrangement as an operating lease. At that time, the lease did not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee (see Example 17 above).

In 20X3 it became apparent that the lessee would use the leased barge for all of its economic life. This indicates that significantly all the risks and rewards of ownership of the barge have now passed from the lessor to the lessee (see paragraph 20.5(c)). However, the lessor and the lessee do not reclassify the lease because there has been no change to the provisions of lease.

Example – classification re-evaluated

Ex 19 **The facts are the same as in Example 16. However, in this example, on 31 December 20X4 the lessor and the lessee agreed to amend the lease to replace the purchase option with the compulsory transfer of ownership of the leased barge to the lessee in return for a payment from the lessee of CU20,000.**

At the inception of the lease the lessee and the lessor classified the arrangement as an operating lease. At that time, the lease did not transfer substantially all the risks and rewards incidental to ownership from the lessor to the lessee (see Example 17 above).

On 31 December 20X4 both the lessor and the lessee would reclassify the lease as a finance lease (see paragraph 20.8) (ie they would cease accounting for the lease as an operating lease and start to account for the amended lease as a finance lease).
The lessor and the lessee agreed to change the provisions of the lease. The terms of the amended lease transfer significantly all the risks and rewards of ownership of the barge from the lessor to the lessee—the lease transfers ownership of the asset to the lessee by the end of the lease term (see paragraph 20.5(a)).

Financial statements of lessees—finance leases

Initial recognition

20.9 At the commencement of the lease term, a lessee shall recognise its rights of use and obligations under finance leases as assets and **liabilities** in its **statement of financial position** at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, determined at the inception of the lease. Any initial direct costs of the lessee (incremental costs that are directly attributable to negotiating and arranging a lease) are added to the amount recognised as an asset.

Notes

Although the term *commencement of the lease term* is not defined in the *IFRS for SMEs* Standard, it is generally understood to mean the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

In the examples that follow the lease term begins at the inception of the lease.

When the lease term does not begin at the inception of the finance lease, the amounts to be recognised at the commencement of the lease term are determined at the inception of the lease.

Any initial direct costs that are directly attributable to the lease are added to the carrying amount of the leased asset. Paragraph 20.9 defines initial direct costs as incremental costs that are directly attributable to negotiating and arranging a lease, ie the costs that would not have been incurred if the entity had not negotiated and arranged a lease. An example is a commission cost that would not be incurred if the lease had not been negotiated and arranged.

Examples – lessee—initial recognition of finance leases

Ex 20 **The facts are the same as in Example 10. For ease of reference the facts are repeated below.**

On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of 10 years, at the end of which it is expected to have no value.

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

On 31 December of each of the first four years of the lease term the lessee is required to pay the lessor CU23,000. At the end of the lease term ownership of the machine transfers to the lessee upon payment of the final lease payment of CU23,539.

The interest rate implicit in the lease is 5% per year which approximates the lessee's incremental borrowing rate.

On 1 January 20X1 the lessee recognises the leased machine (as an item of property, plant and equipment) and a finance lease liability measured at CU100,000 (fair value of the leased machine at the inception of the lease, which is the same as the present value of the minimum lease payments (see table in Example 10), by recording the following journal entry:

Dr	Property, plant and equipment (machine)	CU100,000	
	Cr Finance lease liability		CU100,000

To recognise the leased machine and the obligation to pay the lessor under the finance lease.

Ex 21 **The facts are the same as in Example 20. However, in this example, the lessee incurred (and paid) CU1,000 brokerage fees and legal costs in arranging the lease of the machine.**

The brokerage fees and legal costs are incremental costs that are directly attributable to negotiating and arranging the lease. They form part of the cost of the leased asset, and are accounted for as follows:

Dr	Property, plant and equipment (machine)	CU1,000	
	Cr Cash		CU1,000

To recognise the initial direct costs of entering into the finance lease.

Note: These journal entries are in addition to the journal entries in Example 20.

20.10 The present value of the minimum lease payments shall be calculated using the **interest rate implicit in the lease**. If this cannot be determined, the **lessee's incremental borrowing rate** shall be used.

Notes

The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this can be determined.

Although the term *interest rate implicit in the lease* is not defined in the *IFRS for SMEs* Standard, in this training material it is understood to have the same meaning as defined in full IFRS Standards (see paragraph 4 of IAS 17)[(2)], ie

- the **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments

[(2)] In the absence of explicit guidance in the *IFRS for SMEs* Standard an entity can, applying paragraph 10.6, consider the requirements and guidance in full IFRSs. IAS 17 *Leases* is no longer in application because it has been superseded with IFRS 16 *Leases*. However, this module includes reference to IAS 17 because Section 20 is based on that Standard.

and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset (ii) any initial direct costs of the lessor.

If the interest rate implicit in the lease is not determinable, then the lessee's incremental borrowing rate should be used. The Glossary of the *IFRS for SMEs* Standard defines **lessee's incremental borrowing rate of interest** as the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Subsequent measurement

20.11 A lessee shall apportion minimum lease payments between the finance charge and the reduction of the outstanding liability using the **effective interest method** (see paragraphs 11.15–11.20). The lessee shall allocate the finance charge to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. A lessee shall charge contingent rents as **expenses** in the periods in which they are incurred.

Notes

The lease payments are split into two components: the finance charge for the period and the repayment of the lease liability. Applying paragraph 20.11, the interest charge is determined so that a constant periodic rate of interest is recognised on the outstanding balance of the liability.

Examples – lessee—subsequent measurement of finance leases

Ex 22 **The facts are the same as in Example 10 as repeated in Example 20**

At the commencement of the lease term (in accordance with paragraph 20.9) the entity recognised the asset (machine) and the liability (finance lease obligation) measured at CU100,000 (the fair value of the leased machine at the inception of the lease, which is the same as the present value of the minimum lease payments (see table in Example 10).

To apportion the lease payments between the finance charge and the reduction of the outstanding liability, the rate that produces a constant periodic rate of interest on the remaining balance of the liability is calculated. The interest rate implicit in the lease can be calculated using a financial calculator or, as was done in this case, by using a spreadsheet—by changing cell D8 until the interest rate is found that results in cell E6 being equal to nil:

	A	B	C	D	E
1	*Year*	*Lease liability at 1 January*	*Finance cost*	*Payment*	*Lease liability at 31 December*
2	20X1	100,000	=B2*D8	(23,000)	=B2+C2+D2
3	20X2	=E2	=B3*D8	(23,000)	=B3+C3+D3
4	20X3	=E3	=B4*D8	(23,000)	=B4+C4+D4
5	20X4	=E4	=B5*D8	(23,000)	=B5+C5+D5
6	20X5	=E5	=B6*D8	(23,539)	=B6+C6+D6
7					
8			Interest rate =	5.00%	

The lease amortisation table results

	A	B	C	D	E
	Year	*Lease liability at*			*Lease liability at*
1		*1 January*	*Finance cost*	*Payment*	*31 December*
2	20X1	100,000	5,000	(23,000)	82,000
3	20X2	82,000	4,100	(23,000)	63,100
4	20X3	63,100	3,155	(23,000)	43,255
5	20X4	43,255	2,163	(23,000)	22,418
6	20X5	22,418	1,121	(23,539)	Nil

The subsequent apportionment of the lease payments between the finance charge and the reduction of the outstanding liability is recorded by the processing the following journal entries:

31 December 20X1

Dr	Profit or loss—finance cost	CU5,000	
Dr	Finance lease liability	CU18,000	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X2

Dr	Profit or loss—finance cost	CU4,100	
Dr	Finance lease liability	CU18,900	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X3

Dr	Profit or loss—finance cost	CU3,155	
Dr	Finance lease liability	CU19,845	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X4

Dr	Profit or loss—finance cost	CU2,163	
Dr	Finance lease liability	CU20,873	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X5

Dr	Profit or loss—finance cost	CU1,121	
Dr	Finance lease liability	CU22,418	
	Cr Cash		CU23,539

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

Ex 23 **The facts are the same as in Example 22. However, in this example, in addition to the minimum lease payments the lessee paid CU1,000 contingent rent to the lessor on 31 December 20X1.**

In addition to the journal entries presented in the answer to Example 23, the entity would account for the contingent rent as follows:

31 December 20X1

Dr	Profit or loss—contingent rent	CU1,000	
	Cr Cash		CU1,000

To recognise payment of contingent rent.

Note: These journal entries are in addition to the journal entries in Example 23.

Ex 24 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of five and a half years, at the end of which it is expected to have no value.**

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

On 31 December for each year of the lease term the lessee is required to pay the lessor CU23,000. At the end of the lease term ownership of the machine will pass to an independent third party upon payment of CU539 by that party.

At the inception of the lease the lessee classified the lease as a finance lease.

If the lessee is familiar with the terms of the contract between the lessor and the independent third party and knows the fair value of the machine at inception, the lessee can use that information to determine the interest rate implicit in the lease. The interest rate implicit in the lease can be calculated using a financial calculator or, as was done in this case, by using a spreadsheet—by changing cell D8 until the interest rate is found that results in cell E6 being equal to CU539 (the amount at which the independent third party is obliged to acquire the leased asset from the lessor at the end of the lease):

	A	B	C	D	E
		Lease liability at			*Lease liability at*
1	*Year*	*1 January*	*Finance cost*	*Payment*	*31 December*
2	20X1	100,000*	=B2*D8	(23,000)	=B2+C2+D2
3	20X2	=E2	=B3*D8	(23,000)	=B3+C3+D3
4	20X3	=E3	=B4*D8	(23,000)	=B4+C4+D4
5	20X4	=E4	=B5*D8	(23,000)	=B5+C5+D5
6	20X5	=E5	=B6*D8	(23,000)	=B6+C6+D6
7					
8			Interest rate =	5.00%	

* *Note: if the lessee is not familiar with the terms of third party contract, or does not know the fair value of the lease, it could alternatively perform the calculation using only the payments it is required to make, and its own incremental borrowing rate. If its incremental borrowing rate is 5%, the outcome would be the same. Applying excel, this would be calculated as =PV(rate,nper,pmt) or =(PV(5%,5,23000).*

The present value of the minimum lease payments discounted using the interest rate implicit in the lease (CU99,578) can be calculated using a financial calculator or, as was done in this case, by using a spreadsheet:

A	B	C	D

1	*Year*	*Payment*	*Discount factor*	*Present value*
2	31 December 20X1	23,000	=1.05	=B2/C2
3	31 December 20X2	23,000	=1.05*C2	=B3/C3
4	31 December 20X3	23,000	=1.05*C3	=B4/C4
5	31 December 20X4	23,000	=1.05*C4	=B5/C5
6	31 December 20X5	23,000	=1.05*C5	=B6/C6
7				
8			PV =	=SUM(D2:D6)

On 1 January 20X1 the lessee recognises the leased machine (as an item of property, plant and equipment) and a finance lease liability measured at the lower of the present value of the future minimum lease payments (CU99,578) and the fair value of the leased machine at the inception of the lease (CU100,000), by recording the following journal entry:

Dr	Property, plant and equipment (machine)	CU99,578	
	Cr Finance lease liability		CU99,578

To recognise the leased machine and the obligation to pay the lessor under the finance lease.

To apportion the lease payments between the finance charge and the reduction of the outstanding liability the rate that produces a constant periodic rate of interest on the remaining balance of the liability is established.

The lease amortisation table results (finance cost is calculated at 5% of the outstanding balance at 1 January)

	A	B	C	D	E
1	*Year*	*1 January*	*Finance cost*	*Payment*	*31 December*
2	20X1	99,578	4,979	(23,000)	81,557
3	20X2	81,557	4,078	(23,000)	62,635
4	20X3	62,635	3,132	(23,000)	42,767
5	20X4	42,767	2,138	(23,000)	21,905
6	20X5	21,905	1,095	(23,000)	Nil

The subsequent apportionment of the lease payments between the finance charge and the reduction of the outstanding liability is recorded by the processing the following journal entries:

31 December 20X1

Dr	Profit or loss—finance cost	CU4,979	
Dr	Finance lease liability	CU18,021	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X2

Dr	Profit or loss—finance cost	CU4,078	
Dr	Finance lease liability	CU18,922	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X3

Dr	Profit or loss—finance cost	CU3,132	
Dr	Finance lease liability	CU19,868	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X4

Dr	Profit or loss—finance cost	CU2,138	
Dr	Finance lease liability	CU20,862	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

31 December 20X5

Dr	Profit or loss—finance cost	CU1,095	
Dr	Finance lease liability	CU21,905	
	Cr Cash		CU23,000

To recognise apportionment of the lease payments between the finance charge and the reduction of the outstanding liability.

20.12 A lessee shall depreciate an asset leased under a finance lease in accordance with the relevant section of this Standard for that type of asset, for example, Section 17 *Property, Plant and Equipment*, Section 18 or Section 19 *Business Combinations and Goodwill*. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its **useful life**. A lessee shall also assess at each **reporting date** whether an asset leased under a finance lease is impaired (see Section 27 *Impairment of Assets*).

Notes

Assets held under finance lease are depreciated on the same basis as other depreciable assets owned by the entity and applying the principles of Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill.*

The period over which the asset is depreciated is determined based on whether the lessee will obtain ownership by the end of the lease term. If there is reasonable certainty that ownership will pass to the lessee, the asset is depreciated over its useful life. Otherwise, the asset is depreciated over the shorter of the lease term and its useful life.

Examples – lessee—accounting for leased assets

Ex 25 **The facts are the same as in Example 24.**

The lessee depreciates the machine on the straight-line basis over the five-year lease term (which is equal to its expected useful life—the period over which the machine is expected to be available for use by the lessee) as follows:

Each year ended 31 December 20X1 to 31 December 20X5

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU19,916[(a)]	
	Cr Property, plant and equipment— accumulated depreciation machinery		CU19,916

To recognise the allocation of depreciation for the year.

(a) CU99,578 cost ÷ 5 year lease term (because the lessee surrenders the asset for no value, for its purposes, residual value is zero).

Note: These journal entries are in addition to the journal entries in Example 24.

Ex 26 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable finance lease of a machine that has an economic life of five years and nil residual value.**

On 1 January 20X1 (the inception of the lease) the fair value (cash cost) of the machine is CU100,000 and the present value of the minimum lease payments (discounted at the rate implicit in the lease) is calculated as CU105,000.

The entity depreciates machinery on the straight-line basis.

On 1 January 20X1 the lessee recognised the leased machine as an item of property, plant and equipment at CU100,000—the lower of the fair value of the leased asset (CU100,000) and the present value of the minimum lease payments (CU105,000).

The entity depreciates the machine on the straight-line basis over its expected useful life (ie five years—the period over which the machine is expected to be available for use by the lessee) as follows:

Each year 31 December 20X1 to 31 December 20X5

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU20,000[(a)]	
	Cr Property, plant and equipment— accumulated depreciation machinery		CU20,000

To recognise the allocation of depreciation for the year

(a) CU100,000 cost ÷ 5 year lease term

Ex 27 **The facts are the same as in Example 26. However, in this example, the economic life of the machine is 10 years and the entity intends using the machine for its entire economic life. The machine is expected to be worthless at the end of its useful life. Ownership of the leased machine passes from the lessor to the lessee at the end of the lease.**

Because ownership of the leased machine will pass to the lessee, the lessee benefits from the entire useful life of the machine. The machine is depreciated over its useful life of 10 years on the straight-line basis as follows:

Each year ended 31 December 20X1 to 31 December 20X10

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU10,000 [(a)]	
	Cr Property, plant and equipment— accumulated depreciation machinery		CU10,000

To recognise the allocation of depreciation for the year ended 31 December.

(a) CU100,000 cost ÷ 10 year useful life

Ex 28 **The facts are the same as in Example 27. However, in this example, the lease provides the lessee with an option to acquire the leased machine from the lessor at the end of the lease term for CU1.**

There is reasonable certainty that the lessee will exercise the bargain purchase option and obtain ownership of the machine at the end of the lease term. The entity concludes that if it does exercise its option to acquire the asset, it will continue to use the machine for its full 10-year life. Therefore, the entity depreciates the machine on the straight-line basis over its expected useful life of 10 years (ie the period over which the machine is expected to be available for use by the lessee) to its estimated residual value (nil) as follows:

Each year ended 31 December 20X1 to 31 December 20X10

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU10,000	
	Cr Property, plant and equipment— accumulated depreciation machinery		CU10,000

To recognise the allocation of depreciation for the year ended 31 December.

Ex 29 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable finance lease of a machine that has an economic life of four years and nil residual value.**

On 1 January 20X1 (the inception of the lease) the fair value (cash cost) of the machine is CU100,000.

The entity depreciates machinery on the straight-line basis.

On 1 January 20X1 the lessee recognised the leased machine as an item of property, plant and equipment at CU100,000.

The entity depreciates the machine on the straight-line basis over its expected useful life (ie four years—the period over which the machine is expected to be available for use by the lessee) as follows:

Each year ended 31 December 20X1 to 31 December 20X4

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU25,000	
	Cr Property, plant and equipment—		CU25,000

accumulated depreciation machinery

To recognise the allocation of depreciation for the year ended 31 December.

Disclosures

20.13 A lessee shall make the following disclosures for finance leases:

(a) for each **class of asset**, the net **carrying amount** at the end of the **reporting period**;

(b) the total of future minimum lease payments at the end of the reporting period, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(c) a general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases and restrictions imposed by lease arrangements.

20.14 In addition, the requirements for disclosure about assets in accordance with Sections 17, 18, 27 and 34 apply to lessees for assets leased under finance leases.

Examples – lessee—finance lease disclosures

Ex 30 **The facts are the same as in Example 10 (for lease classification) as repeated in Example 20 (for initial recognition). For ease of reference the facts are repeated below.**

On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of 10 years, at the end of which it is expected to have no value.

At the inception of the lease, the fair value (cash cost) of the machine is CU100,000.

On 31 December of each of the first four years of the lease term the lessee is required to pay the lessor CU23,000. At the end of the lease term ownership of the machine passes to the lessee upon payment of the final lease payment of CU23,539.

The interest rate implicit in the lease is 5% per year, which approximates the lessee's incremental borrowing rate.

In this example, applying Section 17 *Property, Plant and Equipment* the entity depreciates the machine on the straight-line basis over its expected 10-year useful life.

Note: the accounting for the lease on initial recognition is set out in examples 20 and 21.
The subsequent accounting for the leased obligation is set out in examples 22–24 and the subsequent accounting for the leased asset is set out in examples 25–29.

Financial statements for the year ended 31 December 20X3.

Applying Sections 4.2(e), 4.2(m) and 4.4, the lessee presents at least the following in its statement of financial position:

Extract from the lessee's statement of financial position at 31 December 20X3:

	Notes	*20X3*	*20X2*
		CU	*CU*
ASSETS			
Non-current assets			
Property, plant and equipment	8	70,000	80,000
…			
EQUITY AND LIABILITIES			
Non-current liabilities			
Obligations under finance leases	12	22,418	43,255
…			
Current liabilities			
Current portion of obligations under finance leases	12	20,837	19,845

Applying Section 5.5(b), the lessee presents at least the following in its statement of comprehensive income:

Extract from the lessee's statement of comprehensive income at 31 December 20X3:

	Notes	*20X3*	*20X2*
		CU	*CU*
Finance costs		(3,155)	(4,100)

Applying Sections 7.6(c), 7.10, 7.14 and 7.15, the lessee presents the following in its statement of cash flows:

Extract from the lessee's statement of cash flows at 31 December 20X3:

	Notes	*20X3*	*20X2*
		CU	*CU*

Cash flow from operating activities		
Interest paid	(3,155)	(4,100)
…		
Cash flow from financing activities		
Payment of finance lease liabilities	(19,845)	(18,900)
…		

Note: as permitted by paragraph 7.15, the entity has classified interest paid as operating cash flow. Alternatively, an entity may classify interest paid as financing cash flows.

Applying Section 8.5, 20.14 and 17.31(a)-(c), the lessee could disclose the following in its Notes to the Financial Statements:

Extract from the lessee's notes to the financial statements for the year ended 31 December 20X3

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the entity. All other leases are classified as operating leases.

Rights to assets held under finance leases are recognised as assets of the entity at the fair value of the leased property (or, if lower, the present value of minimum lease payments) at the inception of the lease. The corresponding liability to the lessor is included in the statement of financial position as a finance lease obligation.

Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognised in profit or loss. Assets held under finance leases are included in property, plant and equipment, and depreciated and assessed for impairment losses in the same way as owned assets. Contingent rents are recognised as expenses in profit or loss of the period in which they are incurred.

Property, plant and equipment

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

Depreciation is charged so as to allocate the cost of the assets less their residual values over their estimated useful lives, using the straight-line method. Machinery is depreciated at the rate of 10% per year.

Assets held under finance leases are fully depreciated over the shorter of the lease term and the asset's useful life if there is no reasonable certainty that ownership of the asset will be obtained.

Applying Sections 20.14, 17.31(d)-(e) and 17.32(a), the lessee could disclose the following in its Notes to the Financial Statements:

Note 8 Property, plant and equipment

Machine	*20X3*	*20X2**
1 January	*CU*	*CU*
Cost	100,000	100,000
Accumulated depreciation	(20,000)	(10,000)
Carrying amount	80,000	90,000
Annual depreciation	(10,000)	(10,000)

31 December	70,000	80,000
Analysed as follows:		
Cost	100,000	100,000
Accumulated depreciation	(30,000)	(20,000)
Carrying amount	70,000	80,000

The machine is held under a finance lease (see Note 12).

* Note: The entity need not provide the comparative figures presented in this reconciliation (see paragraphs 20.14 and 17.31(e)). The entity has voluntarily provided the comparative information.

Applying Sections 20.13, the lessee could disclose the following in its Notes to the Financial Statements:

Note 12 Obligations under finance leases[(b)]

The entity holds a machine with an estimated useful life of 10 years under a five-year finance lease. At the end of the lease term, when the final lease payment is made, ownership of the machine passes to the entity. The future minimum lease payments are as follows:

	20X3	*20X2*
	CU	*CU*
Within one year	23,000 [(a)]	23,000 [(a)]
Later than one year but within five years	23,539	46,539
Later than five years	–	–
	46,539	69,539
Future finance costs	(3,284) [(b)]	(6,439) [(b)]
Lease liability	43,255 [(a)]	63,100 [(a)]

The obligation is classified as:

	20X3	*20X2*
	CU	*CU*
Current liability	20,837 [(c)]	19,845 [(c)]
Non-current liability	22,418	43,255
Total lease liability	43,255 [(a)]	63,100 [(a)]

There is no contingent rent.

The lease liabilities are secured on the related machinery (see note 8).

The following table is included to aid understanding of the amounts presented in the financial statements but do not form part of the disclosure. It sets out the amortisation of the lease liability over the lease term.

[(a)]

Year	*Lease liability at 1 January*	*Finance cost*	*Payment*	*Lease liability at 31 December*
20X1	100,000	5,000	(23,000)	82,000
20X2	82,000	4,100	(23,000)	63,100

20X3	63,100	3,155	(23,000)	43,255
20X4	43,255	2,163	(23,000)	22,418
20X5	22,418	1,121	(23,539)	nil

(b) Future finance costs:

20X2: CU3,155 + CU2,163 + CU1,121 = CU6,439

20X3: CU CU2,163 + CU1,121 = CU3,284

(c) Current portion of lease liability
20X2: CU23,000 – CU3,155 (ie 20X3 finance cost) = CU19,845
20X3: CU23,000 – CU2,163 (ie 20X4 finance cost) = CU20,837

Ex 31 **The facts are the same as in Example 30. However, in this example, instead of ownership of the machine passing to the lessee at the end of the lease term, on 31 December 20X5 the lessee can exercise an option to renew the lease for a further five-year period. Lease payments for the second five-year period total CU1.**

The answer to this example is the same as the answer to Example 31 except that the entity would disclose the existence and terms of the renewal option as required by paragraph 20.13(c). The disclosure could be made as follows:

The entity holds an option, exercisable on 31 December 20X5, to renew the lease for a further five-year period. Lease payments in the renewal period total CU1. The entity intends to exercise the renewal option.

Ex 32 **The facts are the same as in Example 30. However, in this example, additional lease amounts are payable to the lessor when the machine produces more than 500,000 units in a year. The additional lease payments are calculated at the rate of CU1 per unit produced in excess of 500,000. In 20X3 additional lease payments of CU1,000 were incurred.**

In addition to the disclosures presented in the answer to Example 30, the entity would provide information about the contractual arrangements for contingent rents in the general description of its leasing arrangements as required by paragraph 20.13(c). It could also disclose the contingent rents incurred—the disclosure could be made as follows:

Note 23 Profit before tax
The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Contingent rents[(a)]	1,000	-

…

(a) Contingent rents are incurred when the leased machine produces in excess of 500,000 units in a year. For each unit produced in excess of 500,000 units, contingent rent of CU1 is incurred.

Ex 33 **The facts are the same as in Example 30. However, in this example, in 20X3 the lessee entered (as lessor) into a lease agreement leasing the excess machine**

capacity to an independent third party in return for CU4,000 per year for the three-year period 20X3–20X5.

In addition to the disclosures presented in the answer to Example 31, the entity would provide a general description of the sublease agreement as required by paragraph 20.13(c). The disclosures could be made as follows:

The entity leases the excess machine capacity to an independent third party under an operating lease in return for CU4,000 per year for the three-year period 20X3–20X5.

Financial statements of lessees—operating leases

Recognition and measurement

20.15 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense over the lease term on a straight-line basis unless either:

(a) another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases.

If payments to the lessor vary because of factors other than general inflation, then the condition (b) is not met.

Example of applying paragraph 20.15(b):

X operates in a jurisdiction in which the consensus forecast by local banks is that the general price level index, as published by the government, will increase by an average of 10 per cent annually over the next five years. X leases some office space from Y for five years under an operating lease. The lease payments are structured to reflect the expected 10 per cent annual general inflation over the five-year term of the lease as follows

Year 1	CU100,000
Year 2	CU110,000
Year 3	CU121,000
Year 4	CU133,000
Year 5	CU146,000

X recognises annual rent expense equal to the amounts owed to the lessor. If the escalating payments are not clearly structured to compensate the lessor for expected inflationary cost increases based on published indexes or statistics, then X recognises annual rent expense on a straight-line basis: CU122,000 each year (sum of the amounts payable under the lease divided by five years).

Notes

Operating leases are not capitalised. Paragraph 20.15 requires an entity to recognise payments under an operating lease as an expense on a straight-line basis unless another basis is more representative of the time pattern of the user's benefit.

In accordance with other sections of the *IFRS for SMEs* Standard (eg Section 13 *Inventories*) operating lease costs may in some cases form part of the cost of an asset (see paragraph 13.8).

Although the *IFRS for SMEs* Standard does not provide guidance on how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor, an interpretation to full IFRS Standards does include such guidance.

In the absence of explicit guidance in the *IFRS for SMEs* Standard an entity can, applying paragraph 10.6, consider the requirements and guidance, including interpretations in full IFRS Standards.
SIC Interpretation 15 *Operating Leases – Incentives* paragraphs 4 and 5 notes that the conceptual framework in full IFRS requires an entity to consider substance over form (this is similar to the requirement in Section 2.8 of the *IFRS for SMEs* Standard). The interpretation notes that the substance of operating lease arrangements is that the lessor and lessee exchange the use of an asset for a specified period for the consideration of a net amount of money. Thus, the lessee and lessor should consider the net amount of money (including incentives) to be paid by the lessee to the lessor as compensation for the lease.

Examples – lessee—operating lease recognition and measurement

Ex 34 **On 1 January 20X1 an entity entered, as lessee, into a two-year operating lease of a new photocopier. The photocopier has an expected economic life of 10 years. As part of that agreement the lessor agrees to provide maintenance services to the lessee in respect of the photocopier.**

The agreement obliges the lessee to pay CU100 to the lessor on the last day of each month of the lease term. It has been determined with reference to transactions between the lessor and other parties. 20% of the monthly payments are in respect of the maintenance services and 80% of the payments are for the lease.

The lease of the photocopier is classified as an operating lease because it does not transfer substantially all the risks and rewards incidental to ownership. This is evidenced by the fact that the lease term is not for the major part of the economic life of the photocopier.

The arrangement is separated into its two components (ie the lease and the maintenance services).

The maintenance services are recognised as an expense in profit or loss of the period in which they are incurred (ie when the services are received).

The operating lease payments are accounted for on a straight-line basis in accordance with paragraph 20.15 (ie CU80 is recognised as an expense in profit or loss of each month).

Ex 35 **The facts are the same as in Example 34. However, in this example, it has been determined that the entity is expected to receive maintenance services of CU140 in January 20X1 and CU340 in February 20X2. In this example the effects of discounting are ignored.**

The arrangement is separated into its two components (ie the lease and the maintenance services) as follows:

	CU
Total payment (CU100 per month × 24 months)	2,400
Payment for maintenance services (CU140 + CU340)	(480)
Operating lease payments	1,920

The expenses related to services are recognised as an expense in the period incurred (ie when the services are received). Assuming that the straight-line basis of expensing operating lease payments is appropriate, monthly operating lease expenses would be CU80 (ie CU1,920 ÷ 24 months).
The lessee's journal entries are:

January 20X1

Dr	Profit or loss – service expense	CU140	
Dr	Profit or loss – operating lease expense	CU80	
	Cr Cash		CU100
	Cr Liability – service payable		CU120

To recognise the operating lease and related service expenses in January 20X1 and the liability accrued.

Each month from February 20X1 to July 20X1

Dr	Liability – service payable	CU20	
Dr	Profit or loss – operating lease expense	CU80	
	Cr Cash		CU100

To recognise the monthly operating lease expense and the part settlement of the liability accrued in January 20X1.

Each month from August 20X1 to January 20X2

Dr	Profit or loss – operating lease expense	CU80	
Dr	Asset – prepaid service	CU20	
	Cr Cash		CU100

To recognise the monthly operating lease expense and the prepayment of future service costs.

February 20X2

Dr	Profit or loss – operating lease expense	CU80	
Dr	Profit or loss – service expense	CU340	
	Cr Cash		CU100
	Cr Asset – prepaid service		CU120
	Cr Liability – service payable		CU200

To recognise the operating lease and related service expenses in February 20X2 and the liability accrued.

Each month from March 20X2 to December 20X2

Dr	Profit or loss – operating lease expense	CU80	
Dr	Liability – service payable	CU20	

	Cr Cash		CU100

To recognise the monthly operating lease expense and the part settlement of the liability accrued in February 20X2.

Ex 36 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable operating lease of a building.**

No lease amount is payable for the first four years of the lease. The single lease payment of CU5,000 is due on 1 January 20X5. In this example the effects of discounting are ignored.

The operating lease payments are accounted for on a straight-line basis in accordance with paragraph 20.15 (ie CU1,000 is recognised as an expense in profit or loss of each year of the lease term).

Calculation: CU5,000 total lease payments ÷ 5 years = CU1,000 operating lease expense per year.

Note: By 1 January 20X5 the lessee would have accrued CU4,000 lease payables as a current liability (ie CU1,000 each year from 20X1 to 20X4). By the time of the settlement of the lease obligation, in 1 January 20X5, the lessee would recognise the following journal entry:

Dr	Operating lease liability	CU4,000	
Dr	Prepaid expense	CU1,000	
	Cr Cash		CU5,000

To recognise the settlement of the operating lease liability at 1 January 20X5 and the prepayment for the year.

Ex 37 **The facts are the same as in Example 36. However, in this example, the single lease payment of CU5,000 is due on 1 January 20X1. In this example the effects of discounting are ignored.**

On 1 January 20X1 the payment to the lessor would be recognised as a prepaid expense.

The operating lease payments are accounted for on a straight-line basis in accordance with paragraph 20.15 (ie CU1,000 is recognised as an expense in profit or loss of each year of the lease term).

Calculation: CU5,000 total lease payments ÷ 5 years = CU1,000 operating lease expense per year.

On inception of the lease, on 1 January 20X1, the lessee would recognise the following journal entry:

Dr	Operating lease asset –prepaid expense	CU5,000	
	Cr Cash		CU5,000

To recognise the prepayment for the lease period at 1 January 20X1.

Ex 38 **On 1 January 20X1 an entity entered into a new lease arrangement with a lessor. The lessor agrees to pay the lessee's relocation costs as an incentive to the lessee for entering into the new lease. The lessee's moving costs are CU1,000. The new lease has a term of 10 years, at a fixed rate of CU2,000 per year.**

The entity determines that its total net lease liability is CU19 000, determined as the net of the lease payments of 20 000 and the lease incentive of CU1 000. The operating lease payments are accounted for on a straight-line basis in accordance with paragraph 20.15 (ie CU1,900 is recognised as an expense in profit or loss of each year of the 10 years of the lease term).

The lessee recognises relocation costs of CU1,000 as an expense in the year ended 31 December 20X1.

Calculation:
CU2,000 × 10 years less CU1,000 relocation incentive = CU19,000 net total lease payments. CU19,000 ÷ 10 years = CU1,900 operating lease expense per year.

Ex 39 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable operating lease of a building.**

The lease payments for the year ending 20X1 is CU100,000. Lease payments for 20X2–20X5 are CU100,000 adjusted for expected inflation by applying the expected consumer price index, as follows:

- **20X2: CU105,000**
- **20X3: CU110,250**
- **20X4: CU115,763**
- **20X5: CU121,551**

The amounts are payable yearly in advance (ie on 1 January each year of the lease term).

Because the fixed escalation clause is structured to increase in line with expected general inflation (ie the expected consumer price index) the operating lease payments are recognised as an expense as follows:

- for the year ended 31 December 20X2: CU105,000
- for the year ended 31 December 20X3: CU110,250
- for the year ended 31 December 20X4: CU115,763
- for the year ended 31 December 20X5: CU121,551.

Disclosures

20.16 A lessee shall make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(b) lease payments recognised as an expense; and

(c) a general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

Examples – lessee—operating lease disclosures

Ex 40 **On 1 January 20X1 an entity entered, as lessee, into a non-cancellable lease of a building. The lease has a term of 20 years, at a fixed payment of CU5,000 per year. The amounts are payable in arrears on 31 December of each year.**

The lessee could disclose the lease in the notes to its financial statements for the year ended 31 December 20X3 as follows:

Extract from the lessee's notes to the financial statements for the year ended 31 December 20X3

Applying Section 8.5, the lessee could disclose the following in its Notes to the Financial Statements:

Note 1 Accounting policies

Leases are classified as operating leases when the terms of the lease do not transfer substantially all the risks and rewards of ownership of the leased asset to the entity.

Rentals payable under operating leases are recognised as an expense in profit or loss on a straight-line basis over the term of the relevant lease.

Applying Section 20.16(b), the lessee could disclose the following in its Notes to the Financial Statements:

Note 23 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Minimum lease payments—operating lease	5,000	5,000

Applying Section 20.16(a), the lessee could disclose the following in its Notes to the Financial Statements:

Note 40 Commitments under operating leases

The entity leases a building under a 20-year non-cancellable operating lease.

At year-end, the entity has outstanding commitments under non-cancellable operating leases that fall due as follows:

	20X3		*20X2*	
	CU		*CU*	
- within one year	5,000		5,000	
- later than one year but within five years	20,000		20,000	
- later than five years	60,000		65,000	
Total	85,000	(b)	90,000	(a)

There is no contingent rent.

The following is included to aid understanding of the amounts presented in the financial statements and do not form part of the disclosure:

(a) At 31 December 20X2 total outstanding future minimum lease payments is CU5,000 for the next 18 years (20X2-2020): CU5,000 x 18 years = CU90,000.

(b) At 31 December 20X3 total outstanding future minimum lease payments is CU5,000 for the next 17 years (20X3-2020): CU5,000 x 17 years = CU85,000.

Ex 41 **The facts are the same as in Example 40. However, in this example, the lessor agreed to a rent-free period for the first three years as an incentive to the lessee for entering the new lease (ie the lease in this example has a term of 20 years, at a fixed payment of CU5,000 per year for years 4–20).**

Note: The total lease payments are CU5,000 × 17 = CU85,000. The operating lease expense must be recognised in profit or loss on a straight-line basis over the term of the lease (ie 20 years). CU85,000 ÷ 20 years = CU4,250 per year

The lessee could disclose the lease in its financial statements for the year ended 31 December 20X3 as follows:

Extract from the lessee's statement of financial position at 31 December 20X3:

	Notes	*20X3*		*20X2*	
		CU		*CU*	
EQUITY AND LIABILITIES					
Current liabilities					
Trade and other payables		12,750	(b)	8,500	(a)
…					

Extract from the lessee's notes to the financial statements for the year ended 31 December 20X3

Note 1 Accounting policies

Leases

Leases are classified as operating leases when the terms of the lease do not transfer substantially all the risks and rewards of ownership of the leased asset to the entity.

Rentals payable under operating leases are recognised as an expense in profit or loss on a straight-line basis over the term of the relevant lease.

Note 23 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		

Minimum lease payments—operating lease	4,250	4,250

Note 40 Commitments under operating leases

The entity leases a building under a 20-year non-cancellable operating lease. In accordance with the lease agreement no amount is payable for the first three years of the lease (ie 20X1−20X3) and thereafter payments of CU5,000 are payable per year.

At year-end, the entity has outstanding commitments under non-cancellable operating leases that fall due as follows:

	20X3	*20X2*
	CU	*CU*
- within one year	5,000	–
- later than one year but within five years	20,000	20,000
- later than five years	60,000	65,000
Total	85,000	85,000

The following is included to aid understanding of the amounts presented in the financial statements and do not form part of the disclosure:

(a) The amount of CU 8,500 recognised in trade and other payables at 31 December 20X2 represents the lease payment accrued for 2 years (20X1 and 20X2).

CU4,250 x 2 years = CU8,500

(b) The amount of CU12,750 recognised in trade and other payables at 31 December 20X3 represents the lease payment accrued for 3 years (20X1-20X3).

CU4,250 x 3 years = CU12,750.

(c) Calculations for outstanding commitments under non-cancellable operating lease:

	20X3	*working*	*20X2*	*working*
	CU		*CU*	
- within one year	5,000	20X4	–	20X3 (nil because rent free period)
- later than one year but within five years	20,000	20X5 - 20X8: 5,000 x 4 years = 20,000	20,000	20X4 - 20X7: 5,000 x 4 years = 20,000
- later than five years	60,000	20X9 - 2020: 5,000 x 12 years = 65,000	65,000	20X8 - 2020: 5,000 x 13 years = 65,000
Total	85,000		85,000	

Ex 42 **The facts are the same as in Example 40. However, in this example, additional contingent rents are payable to the lessor when the lessee's revenue exceeds CU5 million in a year. The contingent rents are calculated at the rate of 1% of revenue in excess of CU5 million. In 20X3 contingent rents of CU1,000 were incurred. Before 20X3 the lessee's revenue had not exceeded CU5 million.**

The lessee could disclose the lease in the notes to its financial statements for the year ended 31 December 20X3 as follows:

Extract from the lessee's notes to the financial statements for the year ended 31 December 20X3

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the entity. All other leases are classified as operating leases.

Rentals payable under operating leases are recognised as an expense in profit or loss on a straight-line basis over the term of the relevant lease.

Contingent rents are recognised as an expense in the period in which they are incurred.

Note 23 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Operating lease payments	6,000	5,000
Minimum lease payments	5,000	5,000
Contingent rents[(a)]	1,000	–

…

[(a)] Contingent rents on the leased building are incurred at the rate of 1% of revenue in excess of CU5 million for the year.

Note 40 Commitments under operating leases

The entity leases a building under a 20-year non-cancellable operating lease. In addition to the minimum lease payments, contingent rents are incurred on the leased building at the rate of 1% of revenue in excess of CU5 million for the year. Contingent rents are not included in minimum lease payments and are therefore excluded from the table below.

At year-end, the entity has outstanding commitments under non-cancellable operating leases that fall due as follows:

	20X3	*20X2*
	CU	*CU*

- within one year	5,000		5,000	
- later than one year but within five years	20,000		20,000	
- later than five years	60,000		65,000	
Total	85,000	(b)	90,000	(a)

The following is included to aid understanding of the amounts presented in the financial statements and do not form part of the disclosure:

(a) At 31 December 20X2 total outstanding future minimum lease payments is CU5,000 for the next 18 years (20X2-2020): CU5,000 x 18 years = CU90,000

(b) At 31 December 20X3 total outstanding future minimum lease payments is CU5,000 for the next 17 years (20X3-2020): CU5,000 x 17 years = CU85,000

Ex 43 **The facts are the same as in Example 40. However, in this example, with effect from 2 January 20X1, the lessee entered (as lessor) into a lease agreement leasing the excess floor space to an independent third party in return for CU2,000 per year for the five-year period ending 31 December 20X5.**

The lessee could disclose the lease in its financial statements for the year ended 31 December 20X3 as follows:

Extract from the notes to the financial statements for the year ended 31 December 20X3

Note 1 Accounting policies
Note 10 Other income
Other income includes sub-lease rental income of CU2,000 in both 20X2 and 20X3.

Note 23 Profit before tax
The following items of (income) and expense were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Minimum lease payments—operating lease	5,000	5,000

Note 40 Obligations under operating leases

The entity leases a building under a 20-year non-cancellable operating lease. At year-end, the entity has outstanding commitments under non-cancellable operating leases that fall due to the entity's landlord as follows:

	20X3		*20X2*	
	CU		*CU*	
- within one year	5,000		5,000	
- later than one year but within five years	20,000		20,000	
- later than five years	60,000		65,000	
Total	85,000	(b)	90,000	(a)

The entity has leased under a five-year operating lease part of the building it leases but does not occupy to an independent third party. Future minimum lease payments due from the entity's tenant fall due as follows:

	20X3 *CU*	*20X2* *CU*
- within one year	2,000	2,000
- later than one year but within five years	2,000	4,000
- later than five years	–	–
Total	4,000	6,000

There is no contingent rent.

Financial statements of lessors- finance leases

Initial recognition and measurement

20.17 A lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the **net investment in the lease**. The net investment in a lease is the lessor's **gross investment in the lease** discounted at the interest rate implicit in the lease. The gross investment in the lease is the aggregate of:

(a) the minimum lease payments receivable by the lessor under a finance lease; and

(b) any unguaranteed residual value accruing to the lessor.

Notes

The principle of lease classification is the same for the lessor and the lessee. Therefore, the same definitions of finance and operating leases apply to both lessors and lessees.

At inception a lessor recognises a finance lease receivable at the amount of its net investment in the lease which comprises the minimum lease payments and any unguaranteed residual value accruing to the lessor. The lessor derecognises the leased asset.

Example – lessor—finance leases initial recognition

Ex 44 **On 1 January 20X1 an entity (lessor) acquired a machine to lease to an independent third party under a finance lease for CU100,000. The entity immediately enters into a five-year non-cancellable lease to transfer the right of use of a machine that has an economic life of five years and nil residual value to another independent third party (lessee). The lessee is required to pay the entity four yearly payments of CU23,000 and a final payment of CU23,539 payable yearly in arrears (ie on 31 December of each year). Ownership of the machine passes to the lessee at the end of the lease term. The present value of the lease payments discounted at the interest rate implicit in the lease is CU100,000.**

The arrangement is a finance lease. At the inception of the lease, the lease transfers from the entity to the lessee substantially all the risks and rewards incidental to ownership. This is evidenced by the following factors:

- The lease transfers ownership of the asset to the lessee by the end of the lease term (see paragraph 20.5(a);
- The lease term is for the entire economic life of the asset (both are five-year) (see paragraph 20.5(c); and

- At the inception of the lease the present value of the minimum lease payments amount to all of the fair value of the leased asset (see paragraph 20.5(d).

In substance the lessee owns the asset from the inception of the lease—the entity lent money to the lessee securing repayment of the loan by withholding legal ownership of the machine.

Therefore, the lease is recognised, and the finance lease receivable is measured at the fair value of the leased property or, if lower, the present value of the minimum lease payments.

The initial recognition of the lease is:

1 January 20X1

Dr	Machine acquired to lease	CU100,000	
	Cr Cash		CU100,000

To recognise the asset acquired to lease to an independent third party.

Dr	Finance lease receivable	CU100,000	
	Cr Machine acquired to lease		CU100,000

To recognise finance lease of an asset acquired to lease to another independent third party.

20.18 For finance leases other than those involving manufacturer or dealer lessors, initial direct costs (costs that are incremental and directly attributable to negotiating and arranging a lease) are included in the initial measurement of the finance lease receivable and reduce the amount of **income** recognised over the lease term.

Example – lessor—finance leases initial recognition

Ex 45 **The facts are the same as in Example 44. However, in this example, the lessor incurred (and paid) CU1,000 brokerage fees and legal costs in arranging the lease of the machine. The lessor is not a dealer lessor.**

The brokerage fees and legal costs are incremental costs because they are directly attributable to negotiating and arranging the lease. They form part of the cost of the leased asset, and are accounted for as follows:

The initial recognition of the lease is:

1 January 20X1

Dr	Machine acquired to lease	CU100,000	
	Cr Cash		CU100,000

To recognise the asset acquired to lease to an independent third party.

Dr	Finance lease receivable	CU1,000	
	Cr Cash		CU1,000

To recognise the initial direct costs to negotiate and arrange the finance lease.

Dr	Finance lease receivable	CU100,000	
	Cr Machine acquired to lease		CU100,000

To recognise the finance lease of the asset acquired to lease to another.

Subsequent measurement

20.19 The **recognition** of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. Lease payments relating to the period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income. If there is an indication that the estimated unguaranteed residual value used in computing the lessor's gross investment in the lease has changed significantly, the income allocation over the lease term is revised, and any reduction in respect of amounts accrued is recognised immediately in **profit or loss**.

Example – lessor—finance leases subsequent measurement

Ex 46 **The facts are the same as in Example 44.**

To apportion the lease payments between the finance income and the reduction of the outstanding receivable the rate that produces a constant periodic rate of interest on the remaining balance of the receivable must be established (ie the interest rate implicit in the lease). The computation can be performed using a financial calculator or, as was done in this case, by using a spreadsheet—by changing cell D8 until the interest rate is found that results in cell E6 being equal to nil:

	A	B	C	D	E
1	*Year*	*Lease receivable at 1 January*	*Finance income*	*Payment received*	*Lease receivable at 31 December*
2	20X1	100,000	=B2*D8	(23,000)	=B2+C2+D2
3	20X2	=E2	=B3*D8	(23,000)	=B3+C3+D3
4	20X3	=E3	=B4*D8	(23,000)	=B4+C4+D4
5	20X4	=E4	=B5*D8	(23,000)	=B5+C5+D5
6	20X5	=E5	=B6*D8	(23,539)	=B6+C6+D6
7					
8			Interest rate =	0.05	

The lease amortisation table prepared using the interest rate implicit in the lease (ie 5%) is as follows:

Year	*Lease receivable at 1 January*	*Finance income (5%)*	*Payment received*	*Lease receivable at 31 December*
20X1	100,000	5,000	(23,000)	82,000
20X2	82,000	4,100	(23,000)	63,100
20X3	63,100	3,155	(23,000)	43,255
20X4	43,255	2,163	(23,000)	22,418
20X5	22,418	1,121	(23,539)	nil

The subsequent apportionment of the lease payments between the finance income and the reduction of the outstanding receivable is recorded by processing the following journal entries:

31 December 20X1

Dr	Cash	CU23,000	

	Cr Profit or loss—finance income		CU5,000
	Cr Finance lease receivable		CU18,000

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X2

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU4,100
	Cr Finance lease receivable		CU18,900

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X3

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU3,155
	Cr Finance lease receivable		CU19,845

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X4

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU2,163
	Cr Finance lease receivable		CU20,837

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X5

Dr	Cash	CU23,539	
	Cr Profit or loss—finance income		CU1,121
	Cr Finance lease receivable		CU22,418

To recognise the final lease payments.

Manufacturer or dealer lessors

20.20 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) finance income over the lease term.

20.21 The sales **revenue** recognised at the commencement of the lease term by a manufacturer or dealer lessor is the fair value of the asset or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the entity's policy for outright sales.

Example – dealer lessor—finance leases

Ex 47 **The facts are the same as in Example 45. However, in this example, the entity buys machines for CU50,000 each with a view to selling them (or leasing them out under finance leases) to independent third parties at a 100% mark-up on cost.**

The initial recognition of the machine and the lease are:

1 January 20X1

Dr	Inventories	CU50,000	
	Cr Cash		CU50,000

To recognise the inventory acquired.

Dr	Finance lease receivable	CU100,000	
	Cr Sales		CU100,000

To recognise the sale of inventory by way of finance lease.

Dr	Cost of sales	CU50,000	
	Cr Inventories		CU50,000

To derecognise the inventory sold.

The subsequent apportionment of the lease payments between the finance income and the reduction of the outstanding receivable is recorded by processing the following journal entries:

31 December 20X1

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU5,000
	Cr Finance lease receivable		CU18,000

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X2

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU4,100
	Cr Finance lease receivable		CU18,900

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X3

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU3,155

	Cr Finance lease receivable		CU19,845

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X4

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU2,163
	Cr Finance lease receivable		CU20,837

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X5

Dr	Cash	CU23,539	
	Cr Profit or loss—finance income		CU1,121
	Cr Finance lease receivable		CU22,418

To recognise the final lease payments.

20.22 If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged. Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised.

Notes

Manufacturer or dealer lessors sometimes quote artificially low rates of interest as a marketing strategy in order to attract customers. Paragraph 20.22 restricts the selling price to that which would apply if a market rate of interest were charged. This restriction is required because the use of artificially low rate would overstate the selling profit and understate the finance income in subsequent periods, ie an excessive portion of the total income from the transaction being would be recognised at the time of the sale.

Example – dealer lessor (finance lease)—artificially low rate of interest

Ex 48 **The facts are the same as in Example 47. However, in this example, the sale price is CU108,898 but the entity offers a lease finance at an interest rate of 2% per year (ie the lease agreement remains the same: four yearly payments of CU23,000 and a final payment of CU23,539 payable yearly in arrears (ie on 31 December of each year). A market interest rate for a finance lease with this customer would be 5%.**

The lessor envisages a lease amortisation table prepared using the artificially low interest rate of 2%:

Year	*Lease receivable at 1 January*	*Finance income (2%)*	*Payment*	*Lease receivable at 31 December*
20X1	108,898	2,178	(23,000)	88,076
20X2	88,076	1,761	(23,000)	66,837
20X3	66,837	1,337	(23,000)	45,174
20X4	45,174	904	(23,000)	23,078

20X5	23,078	461	(23,539)	0

The lease amortisation table is computed using the interest rate implicit in the lease after adjusting for the inflated purchase price (ie 5% as in example 44 and 46):

Year	*Lease receivable at 1 January*	*Finance income (5%)*	*Payment*	*Lease receivable at 31 December*
20X1	100,000	5,000	(23,000)	82,000
20X2	82,000	4,100	(23,000)	63,100
20X3	63,100	3,155	(23,000)	43,255
20X4	43,255	2,163	(23,000)	22,418
20X5	22,418	1,121	(23,539)	nil

The initial recognition of the machine and the lease are:

1 January 20X1

Dr	Inventories	CU50,000	
	Cr Cash		CU50,000

To recognise the inventory acquired.

Dr	Finance lease receivable	CU100,000	
	Cr Sales[(a)]		CU100,000

To recognise the sale of inventory by way of finance lease.

Dr	Cost of sales	CU50,000	
	Cr Inventories		CU50,000

To derecognise the inventory sold.

The subsequent apportionment of the lease payments between the finance income and the reduction of the outstanding receivable is recorded by processing the following journal entries:

31 December 20X1

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU5,000
	Cr Finance lease receivable		CU18,000

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X2

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU4,100
	Cr Finance lease receivable		CU18,900

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X3

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU3,155

	Cr Finance lease receivable		CU19,845

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X4

Dr	Cash	CU23,000	
	Cr Profit or loss—finance income		CU2,163
	Cr Finance lease receivable		CU20,837

To recognise apportionment of the lease payments between the finance income and the reduction of the outstanding lease receivable.

31 December 20X5

Dr	Cash	CU23,539	
	Cr Profit or loss—finance income		CU1,121
	Cr Finance lease receivable		CU22,418

To recognise the final lease payments.

(a) The selling price is restricted to that which would apply if a market rate if interest were charged (ie 5%)

Disclosures

20.23 A lessor shall make the following disclosures for finance leases:

(a) a reconciliation between the gross investment in the lease at the end of the reporting period and the present value of minimum lease payments receivable at the end of the reporting period. In addition, a lessor shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(b) unearned finance income.

(c) the unguaranteed residual values accruing to the benefit of the lessor.

(d) the accumulated allowance for uncollectable minimum lease payments receivable.

(e) contingent rents recognised as income in the period.

(f) a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

Example – lessor disclosures—finance lease

Ex 49 **The facts are the same as in Example 48. For ease of reference the facts are repeated below.**

The entity buys machines for CU50,000 each with a view to selling them (or leasing them out under finance leases) to independent third parties at a 100% mark-up on cost.

On 1 January 20X1 the entity enters into a five-year non-cancellable lease to transfer to another independent third party the right of use of a machine that has an economic life of five years and nil residual value. In accordance with the lease agreement the lessee is required to pay the entity four annual payments of CU23,000 and a final payment of CU23,539 payable yearly in arrears (ie on 31 December of each year). Ownership of the machine passes to the lessee at the end of the lease term. The present value of the lease payments discounted at the interest rate implicit in the lease is CU100,000.

Note: The recognition and measurement of the lease is set out in Example 48.

The lessor could disclose the lease in its financial statements for the year ended 31 December 20X2 as follows:

Applying Sections 4.2(b) and 4.4, the lessor presents at least the following in its statement of financial position:

Extract from the lessor's statement of financial position at 31 December 20X2:

	Notes	*20X2*	*20X1*
		CU	*CU*
ASSETS			
Non-current asset			
Lease receivable	8	43,255	63,100
…			
Current asset			
Current portion of lease receivable	8	19,845	18,900
…			

Applying Section 5.5(a), the lessor could disclose the following in its Notes to the Financial Statements:

Extract from the lessor's statement of comprehensive income at 31 December 20X2:

	20X2	*20X1*
	CU	*CU*
Revenue—from the sale of goods	–	100,000
Cost of goods sold	–	(50,000)

Gross profit	**–**	**50,000**
Finance income	4,100	5,000

…

Extract from the lessor's notes to the financial statements for the year ended 31 December 20X2

Applying Sections 8.5 and 23.20(a), the lessor could disclose the following in its Notes to the Financial Statements:

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the entity. All other leases are classified as operating leases.

The entity uses finance lease agreements to sells goods to its customers. At the commencement of the lease term, the entity recognises revenue from the sale of goods and the rights to receive future lease payments from its customers as a financial asset. Minimum lease payments are apportioned between the finance income and the reduction of the outstanding lease receivable. Finance income is allocated so as to produce a constant periodic rate of interest on the remaining balance of the lease receivable.

Applying Section 20.23(a), the lessor could disclose the following in its Notes to the Financial statements:

Note 8 Lease receivable

The entity uses finance lease agreements to sells goods to its customers. At year-end receivables under finance lease agreements fall due as follows: [(a)]

	20X2			*20X1*		
	Gross investment in the lease	*Unearned finance income*	*Net investment in the lease*	*Gross investment in the lease*	*Unearned finance income*	*Net investment in the lease*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Receivable:						
Within one year	23,000	(3,155)	19,845	23,000	(4,100)	18,900
Later than one year but within five years	46,539	(3,284)	43,255	69,539	(6,439)	63,100
Total	**69,539**	**6,439**	**63,100**	**92,539**	**10,539**	**82,000**

The following is to aid understanding of the calculations underlying amounts in the financial statements and do not form part of the disclosure:

(a) The lease amortisation table prepared using the interest rate implicit in the lease (ie 5%) is as follows:

Year	*Lease receivable at 1 January*	*Finance income (5%)*	*Payment*	*Lease receivable at 31 December*
20X1	100,000	5,000	(23,000)	82,000
20X2	82,000	4,100	(23,000)	63,100
20X3	63,100	3,155	(23,000)	43,255
20X4	43,255	2,163	(23,000)	22,418
20X5	22,418	1,121	(23,539)	nil

Gross investment in the lease:

20X1: later than one year but within five years (20X3, 20X4 & 20X5): CU23,000 + CU23,000 + CU24,539 = CU69,539
20X2: later than one year but within five years (20X4 & 20X5): CU23,000 + CU24,539 = CU46,539

Financial statements of lessors- operating leases

Recognition and measurement

20.24 A lessor shall present assets subject to operating leases in its **statement of financial position** according to the nature of the asset.

20.25 A lessor shall recognise lease income from operating leases (excluding amounts for services such as insurance and maintenance) in profit or loss on a straight-line basis over the lease term, unless either:

(a) another systematic basis is representative of the time pattern of the lessee's benefit from the leased asset, even if the receipt of payments is not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases.

If payments to the lessor vary according to factors other than inflation, then condition (b) is not met.

20.26 A lessor shall recognise as an expense costs, including **depreciation**, incurred in earning the lease income. The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets.

Examples – lessor—operating leases

Ex 50 **On 1 January 20X1 an entity acquired a machine at a cost of CU5,000. The machine has an economic life of six years and nil residual value.**

On 2 January 20X1 the entity entered, as lessor, into a two-year non-cancellable operating lease of a machine. As part of that agreement the entity agrees to provide maintenance services to the lessee in respect of the machine.

The agreement obliges the lessee to pay CU100 to the entity on the last day of each month of the lease term. It has been determined with reference to transactions between the entity and other parties that 20% of the monthly payments are in respect of the maintenance services (ie 80% of the payments are in respect of the lease).

The arrangement is separated into its two components (ie the lease and the maintenance services).

The maintenance services are recognised as income in profit or loss in accordance with paragraphs 23.14–23.16.

The operating lease payments are accounted for in accordance with paragraph 20.25 (ie CU960 (calculation: 80% × CU100 monthly payment × 12 months) is recognised as income in profit or loss of each year of the lease term).

The machine is depreciated on the straight-line method to a nil residual value in accordance with Section 17 *Property, Plant and Equipment* (ie CU833 per year—calculation:

CU5,000 ÷ 6 years = CU833 per year). The depreciation is recognised as an expense in profit or loss.

Ex 51 **On 1 January 20X1 an entity entered, as lessor, into a five-year non-cancellable operating lease of a building it completed constructing earlier that day at a cost of CU800,000. The building has an economic life of 60 years and nil residual value.**

The entity accounts for the building as property, plant and equipment using the cost model because the fair value of the property cannot be measured reliably without undue cost or effort.

No lease amount is payable for the first four years of the lease. The single lease payment of CU150,000 is due on 1 January 20X5.

The operating lease payments are accounted for in accordance with paragraph 20.25 (ie CU30,000 is recognised as income in profit or loss of each year of the lease term—calculation: CU150,000 total lease payments ÷ 5 years = CU30,000 income per year).

Note: By 1 January 20X5 the lessor would have accrued CU120,000 lease receivables as a current asset (ie CU30,000 related to 20X1 + CU30,000 related to 20X2 + CU30,000 related to 20X3 + CU30,000 related to 20X4).

On 1 January 20X5 the lessor could recognise the following journal entry:

Dr	Cash	CU150,000	
	Cr Operating lease receivable		CU120,000
	Cr Lease income received in advance		CU30,000

To recognise the payment received from the lessee on 1 January 20X5.

The property is depreciated on the straight-line method to a nil residual value (see Section 16 *Investment Property* and Section 17 *Property, Plant and Equipment*) (ie CU13,333 per year—calculation: CU800,000 ÷ 60 years = CU13,333 per year). The depreciation is recognised as an expense in profit or loss.

Ex 52 **The facts are the same as in Example 52. However, in this example, the single lease payment of CU150,000 is due on 1 January 20X1.**

On 1 January 20X1 the payment from the lessee would be recognised as a liability (lease income received in advance).

The operating lease payments are accounted for in accordance with paragraph 20.25 (ie CU30,000 is recognised as income in profit or loss of each year of the lease term—calculation: CU150,000 total lease payments ÷ 5 years = CU30,000 income per year).

The property is depreciated on the straight-line method to a nil residual value (ie CU13,333 per year—calculation: CU800,000 ÷ 60 years = CU13,333 per year).

The depreciation is recognised as an expense in profit or loss.
On 1 January 20X1 the lessor could recognise the following journal entry:

Dr	Cash	CU150,000	
	Cr Lease income received in advance		CU150,000

To recognise the payment received from the lessee on 1 January 20X1.

20.27 A lessor shall add to the carrying amount of the leased asset any initial direct costs it incurs in negotiating and arranging an operating lease and shall recognise such costs as an expense over the lease term on the same basis as the lease income.

Example – lessor—operating lease initial direct costs

Ex 53 **The facts are the same as in Example 51. However, in this example, the lessor incurred costs of CU2,000 in negotiating and arranging the operating lease.**

The CU2,000 initial direct costs are added to the cost of the investment property and accounted for as a separate component of that investment property. The initial direct costs component of the investment property is depreciated over the lease term. Consequently, in addition to the CU13,333 depreciated on the investment property (see example 52) CU400 depreciation for will arise in each of the five years of the lease term—calculation: CU2,000 ÷ 5 years = CU400 per year. The depreciation is recognised as an expense in profit or loss.

20.28 To determine whether a leased asset has become impaired, a lessor shall apply Section 27.

20.29 A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Disclosures

20.30 A lessor shall disclose the following for operating leases:

(a) the future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(b) total contingent rents recognised as income; and

(c) a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses and restrictions imposed by lease arrangements.

Examples – lessor—disclosures operating lease

Ex 54 **On 1 January 20X1 an entity entered, as lessor, into a 20-year non-cancellable operating lease over a building it completed constructing earlier that day at a cost of CU800,000. Lease payments of CU30,000 per year are payable yearly in advance on 1 January.**

The entity accounts for the building using the cost model in accordance with Section 17 *Property, Plant and Equipment* because it cannot determine the fair value of the building reliably without undue cost or effort on an ongoing basis. The building has an economic life of 60 years and nil residual value.

Note: Assume the lessor only has operating lease agreements.

The lessor could disclose the lease in the notes to its financial statements for the year ended 31 December 20X3 as follows:

Extract from the lessor's notes to the financial statements for the year ended 31 December 20X3

Applying Sections 8.5 and 20.23(a), the lessor could disclose the following in its Notes to the Financial Statements:

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the lessee. All other leases are classified as operating leases.

Minimum lease payments receivable under operating leases are recognised as revenue on a straight-line basis over the term of the lease.

Applying section 5.5(a), the lessor could disclose the following in its Notes to the Financial Statements:

Note 23 Revenue

Revenue comprises:

	20X3	*20X2*
	CU	*CU*
Revenue		
Lease income	30,000	30,000
…		

Note 26 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Depreciation	13,333	13,333
…		

Applying Sections 20.30, the lessor could disclose the following in its Notes to the Financial Statements:

Note 40 Operating lease commitments

The entity has entered, as lessor, into a 20-year non-cancellable operating lease of an investment property (see note 15 Investment Property carried at cost less accumulated depreciation and impairment). Outstanding future minimum lease payments of CU30,000 per year fall due from the tenant under the non-cancellable operating lease as follows:

	20X3	*20X2*
	CU	*CU*
- within one year	30,000	30,000
- later than one year but within five years	120,000	120,000
- later than five years	360,000	390,000
Total	510,000	540,000

There is no contingent rent.

Ex 55 **The facts are the same as in Example 54. However, in this example, the entity (as lessor) agreed to a rent-free period for the first three years as incentive to the lessee for entering into the new lease (ie the lease in this example has a term of 20 years). In accordance with the lease no amount is payable during 20X1–20X3. Thereafter (for the next 17 years) a fixed payment of CU30,000 per year is payable each year).**

The lessor could disclose the lease in its statement of financial position and notes to its financial statements for the year ended 31 December 20X3 as follows:

Applying Sections 4.2(b) and 4.4, the lessor presents at least the following in its statement of financial position:

Extract from the lessor's statement of financial position at 31 December 20X3:

	Notes	*20X3*	*20X2*
		CU	*CU*
ASSETS			
Current assets			
Trade receivables		76,500	51,000
…			

Extract from the lessor's notes to the financial statements for the year ended 31 December 20X3

Applying Sections 8.5 and 23.20(a), the lessor could disclose the following in its Notes to the Financial Statements:

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the lessee. All other leases are classified as operating leases.

Minimum lease payments receivable under operating leases are recognised as revenue on a straight-line basis over the term of the lease.

Applying Section 5.5(a), the lessor could disclose the following in its Notes to the Financial Statements:

Note 23 Revenue

Revenue comprises:

	20X3	*20X2*
	CU	*CU*
Lease income	25,500	25,500
…		

Note 26 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Depreciation—investment property	13,333	13,333
…		

Note 40 Operating lease commitments

The entity has entered, as lessor, into a 20-year non-cancellable operating lease of an investment property. The property is accounted for using the cost model (see note 15 Investment Property carried at cost less accumulated depreciation and impairment) because the entity cannot measure the fair value of the building reliably without undue cost or effort on an ongoing basis. At 31 December 20X3 the remaining term of the lease was 17 years (20X2: 18 years). The entity granted the lessee a rent-free period for the first three years of the lease (20X1–20X3) as incentive to the lessee for entering into the new lease.

At 31 December the future minimum lease payments under non-cancellable operating leases are CU30,000 per year for the next 17 years, of which CU76,500 has been recognised as a receivable at 31 December 20X3 (20X2: CU51,000). Outstanding future minimum lease payments of CU30,000 per year fall due from the tenant under the non-cancellable operating lease as follows:

	20X3	*20X2*
	CU	*CU*
- within one year	30,000	–
- later than one year but within five years	120,000	120,000
- later than five years	360,000	390,000
Total	510,000	510,000

There is no contingent rent.

Ex 56 **The facts are the same as in Example 54. However, in this example, in accordance with the lease agreement additional amounts are payable to the lessor when the lessee's revenue exceeds CU5 million in a year. The additional payments are calculated at the rate of 1% of revenue in excess of CU5 million. In 20X3 additional payments of CU1,000 were incurred. Before 20X3 the lessee's revenue had not exceeded CU5 million.**

The lessee could disclose the lease in the notes to its financial statements for the year ended 31 December 20X3 as follows:

Extract from the lessor's notes to the financial statements for the year ended 31 December 20X3

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the lessee. All other leases are classified as operating leases.

Minimum lease payments receivable under operating leases are recognised as revenue on a straight-line basis over the term of the lease.

Note 23 Revenue

Revenue comprises:

	20X3	*20X2*
	CU	*CU*
Revenue		
Lease income	31,000	30,000
Minimum lease payments	30,000	30,000
Contingent rents	1,000	–

…

Note 26 Profit before tax

The following items were recognised in profit before tax:

	20X3	*20X2*
	CU	*CU*
Expenses		
Depreciation—investment property	13,333	13,333
…		

Note 40 Operating lease commitments

The entity has entered, as lessor, into a 20-year non-cancellable operating lease of an investment property that is accounted for using the cost model because the entity cannot determine the building fair value reliably without undue cost or effort on an ongoing basis (see note 15 Investment Property carried at cost less accumulated depreciation and impairment). (see note 15 Property, Plant and Equipment). In addition to the minimum lease payments, contingent rents are earned on the investment property at the rate of 1% of the lessee's revenue to the extent that it exceeds CU5 million for the year. Outstanding future minimum lease payments of CU30,000 per year fall due from the tenant under the non-cancellable operating lease as follows:

	20X3	*20X2*
	CU	*CU*
- within one year	30,000	30,000
- later than one year but within five years	120,000	120,000
- later than five years	360,000	390,000
Total	510,000	540,000

20.31 In addition, the requirements for disclosure about assets in accordance with Sections 17, 18, 27 and 34 apply to lessors for assets provided under operating leases.

Sale and leaseback transactions

20.32 A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends on the type of lease.

Sale and leaseback transaction results in a finance lease

20.33 If a sale and leaseback transaction results in a finance lease, the seller-lessee shall not recognise immediately, as income, any excess of sales proceeds over the carrying amount. Instead, the seller-lessee shall defer such excess and amortise it over the lease term.

Notes

The accounting for sale and leaseback transactions depends on the type of lease entered into. A leaseback is a finance lease if the seller-lessee retains substantially all the risks and rewards incidental to ownership (paragraph 20.4). To make this classification assessment, an entity applies the guidance for classification outline in paragraphs 20.4–20.8. A finance sale and leaseback arrangement is essentially a financing transaction (ie the purchaser-lessor provides finance to the seller-lessee, with the asset as security). For this reason, it is not appropriate for the seller-lessee to recognise the excess of sales proceeds over the carrying amount in profit or loss immediately. It is instead recognised in profit over the lease term.

Although the substance of a sale and leaseback arrangement is a financing transaction, the accounting does not follow the substance because the accounting is simplified.

Example – finance sale and leaseback

Ex 57 **On 1 January 20X1 an entity sells a machine with a carrying amount of CU90,000 to an independent third party for CU120,000 (the fair value of the machine). As part of the arrangement the seller enters into a three-year finance lease arrangement to lease the same machine back from the buyer.**

In accordance with the lease CU44,066 is payable in arrears on 31 December of each year of the lease term.

On 31 January 20X1 the remaining economic life of the machine was estimated as three years with nil residual value.

The interest rate implicit in the lease is 5% per year.

Finance lease obligation amortisation table:

Year	*Discount factor*	*Payment*	*Present value of payment*
20X1	1.050	(44,066)	41,968
20X2	1.103	(44,066)	39,967
20X3	1.158	(44,066)	38,065
Total			**120,000**

To account for this transaction, the seller-lessee recognise the sale of the machine and the credit is accounted as deferred income (ie cash received in advance but cannot be recognised immediately). The deferred income is then amortised over the lease term.

The machine is recognised at its fair value at the date of the sale and leaseback transaction (ie 1 January 20X1) and this become the amount on which subsequent depreciation is computed.

The seller-lessee makes the following accounting entries relating to the sale and finance leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU120,000	
	Cr Property, plant and equipment		CU90,000
	Cr Deferred income		CU30,000

To recognise the sale of machine.

Dr	Property, plant and equipment	CU120,000	
	Cr Lease liability		CU120,000

To recognise the finance leaseback of machine.

31 December 20X1

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU40,000	
	Cr Property, plant and equipment		CU40,000

To recognise depreciation on the leased asset—calculation CU120,000 ÷ 3 years.

Dr	Deferred income	CU10,000	
	Cr Profit or loss		CU10,000

To recognise the amortisation of the deferred income on a straight-line basis over the lease term.

Dr	Profit or loss—finance cost	CU6,000	
	Cr Lease liability		CU6,000

To recognise finance cost for the period—calculation: CU120,000 × 5%.

Dr	Lease liability	CU44,066	
	Cr Cash		CU44,066

To recognise payment of the lease obligation.

Sale and leaseback transaction results in an operating lease

20.34 If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, the seller-lessee shall recognise any profit or loss immediately. If the sale price is below fair value, the seller-lessee shall recognise any profit or loss immediately unless the loss is compensated for by future lease payments at below market price. In that case the seller-lessee shall defer and amortise such loss in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the seller-lessee shall defer the excess over fair value and amortise it over the period for which the asset is expected to be used.

Examples – operating sale and leaseback

Ex 58 **On 1 January 20X1 an entity sells a building with a carrying amount of CU85,000 to an independent third party for CU100,000 (the fair value of the building). As part of the arrangement the seller enters into a three-year operating lease arrangement to lease the same building back from the buyer.**

In accordance with the lease, CU9,500 is payable in arrears on 31 December of each year of the lease term.

On 1 January 20X1 the remaining economic life of the building was 25 years with nil residual value.

The seller-lessee makes the following accounting entries relating to the sale and operating leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU100,000	
	Cr Property, plant and equipment		CU85,000
	Cr Profit or loss–gain on disposal of property, plant and equipment		CU15,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss–lease expense	CU9,500	
	Cr Cash		CU9,500

To recognise payment of the lease expense.

Ex 59 **The facts are the same as in Example 58. However, in this example, the building was sold in a distress sale for CU95,000. The seller-lessee was not compensated for the reduced purchase price (ie CU9,500 is payable in arrears on 31 December of each year of the lease term).**

The seller-lessee makes the following accounting entries relating to the sale and operating leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU95,000	
	Cr Property, plant and equipment		CU85,000
	Cr Profit or loss–gain on disposal of property, plant and equipment		CU10,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss–lease expense	CU9,500	
	Cr Cash		CU9,500

To recognise payment of the lease expense.

Ex 60 **The facts are the same as in Example 58. However, in this example, the building was sold for CU95,000 and to compensate the seller-lessee for the reduced purchase price, lease payments of CU7,664 (ie below the market rents of CU9,500) are payable in arrears on 31 December of each year of the lease term.**

The seller-lessee makes the following accounting entries relating to the sale and operating leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU95,000	
	Cr Property, plant and equipment		CU85,000
	Cr Profit or loss–gain on disposal of property, plant and equipment		CU10,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss–lease expense	CU7,664	
	Cr Cash		CU7,664

To recognise payment of the lease expense.

Ex 61 **The facts are the same as in Example 58. However, in this example, the building was sold for CU80,000 and to compensate the seller-lessee for the reduced purchase price, lease payments of CU2,156 (ie below the market rents of CU9,500) are payable in arrears on 31 December of each year of the lease term.**

The seller-lessee makes the following accounting entries relating to the sale and operating leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU80,000	
Dr	Deferred loss	CU5,000	
	Cr Property, plant and equipment		CU85,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss–lease expense	CU2,156	
	Cr Cash		CU2,156

To recognise payment of the lease expense.

Dr	Profit or loss–deferred loss amortised	CU1,667	
	Cr Deferred loss		CU1,667

To recognise the amortisation of the deferred loss—CU5,000 ÷ 3 years.

Ex 62 **On 1 January 20X1 an entity sells a building with a carrying amount of CU85,000 to an independent third party for CU110,000. The fair value of the building is CU95,000. As part of the arrangement the seller enters into a three-year operating lease arrangement to lease the same building back from the buyer.**

In accordance with the lease, CU9,500 is payable in arrears on 31 December of each year of the lease term.

On 1 January 20X1 the remaining economic life of the building was 25 years with nil residual value.

The seller-lessee makes the following accounting entries relating to the sale and operating leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	CU110,000	
	Cr Property, plant and equipment		CU85,000
	Cr Deferred gain - excess of sale price over fair value		CU15,000
	Cr Profit or loss–gain on disposal of property, plant and equipment		CU10,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss–lease expense	CU9,500	
	Cr Cash		CU9,500

To recognise payment of the lease expense.

Dr	Deferred gain	CU5,000	
	Cr Profit or loss-deferred gain amortised		CU5,000

To recognise the amortisation of the deferred gain-CU15,000 ÷ 3 years.

Disclosures

20.35 Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of significant leasing arrangements includes description of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

Example – disclosures

Ex 63 **On 1 January 20X1 an entity sells a building with a carrying amount of CU85,000 to an independent third party for CU110,000 (the fair value of the building). As part of the arrangement the seller enters into a three-year operating lease to lease the same building back from the buyer.**

In accordance with the agreement CU9,500 is payable by the entity to the third party in arrears on 31 December of each year of the lease term.

On 31 January 20X1 the remaining economic life of the building was 25 years with nil residual value.

The lessee could disclose the lease in the notes to its financial statements for the year ended 31 December 20X2 as follows:

Extract from the lessee's notes to the financial statements for the year ended 31 December 20X2

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the entity. All other leases are classified as operating leases. Minimum lease payments payable under operating leases are recognised as an expense in profit or loss on a straight-line basis over the term of the lease.

Note 23 Profit before tax

The following items were recognised in profit before tax:

	20X2	*20X1*
	CU	*CU*
Income		
Gain on disposal of building in sale and operating leaseback transaction	–	25,000
…		
Expenses		
Minimum lease payments—operating lease	9,500	9,500
…		

Note 40 Obligations under operating leases

At 31 December 20X3 the entity has outstanding commitments in the form of future minimum lease payments under a non-cancellable operating lease of a building which it disposed of in a sale and operating leaseback transaction in 20X1, falling due as follows:

	20X2	*20X1*
	CU	*CU*
within one year	9,500	9,500
after one year but before five years	–	9,500
after five years	–	–
	9,500	19,000

There is no contingent rent.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Standard to transactions and events often requires the exercise of judgement, including making estimates. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful when assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity discloses the judgements—apart from those involving estimates—that its management has made when applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, applying paragraph 8.7, an entity discloses information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* Standard require disclosure of information about particular judgements and estimation uncertainties.

Scope

A lease is an agreement whereby the lessor conveys to the lessee in return for payment or a series of payments the right to use an asset for an agreed period of time. In many cases little difficulty is encountered in determining when an arrangement is a lease within the scope of Section 20. However, in other cases significant judgement is required to be applied, for example:

- to determine whether an arrangement that does not take the legal form of a lease contains a lease as defined in Section 20; or
- to determine whether an arrangement with an unrelated party or parties that involves the legal form of a lease contains a lease as defined in Section 20.

An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (eg an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:

- outsourcing arrangements (eg the outsourcing of the data processing functions of an entity).
- arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity.
- take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (eg a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).

Determining whether an arrangement is, or contains, a lease is based on the substance of the arrangement and requires an assessment of whether the arrangement conveys a right to use the asset.

Classification

Leases are of two types, finance lease and operating lease. A finance lease transfers substantially all the risks and rewards incidental to ownership. An operating lease does not.

In many cases little difficulty is encountered in determining the classification of the lease. However, significant judgement is required to classify some leases. The examples and indicators in paragraphs 20.5 and 20.6 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset passes at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Furthermore, when classifying a lease, judgement may be required when assessing the indicators in paragraphs 20.5 when making the classification assessment. For example, paragraph 20.5(c) states that a lease would normally be classified as a finance lease if the lease term is for the major part of the economic life of the asset, even if title is not transferred lease. However, what is considered to be a 'major part' is not defined and an entity may have to use judgements in some cases to make this determination. Similarly, 'substantially all' in paragraph 20.5(d) is not defined and is another term that may require an entity to use its judgement.

Measurement

Significant judgements involve in measuring the estimated cost of a lease may include determining:

- the fair value of the leased property at the inception;
- the useful life of the leased asset if the asset is of a specialised nature;
- the interest rate implicit in the lease or the entity's incremental borrowings rate; and
- the residual value of the leased asset.

COMPARISON WITH FULL IFRS STANDARDS

When the *IFRS for SMEs* Standard was issued in July 2009 and revised in 2015, Section 20 *Leases* is largely based on IAS 17 *Leases* and both standards are substantially the same, except the minor differences noted below. However, in January 2016 the Board issued IFRS 16 *Leases* which supersedes IAS 17. IFRS 16 is effective for annual periods beginning on or after 1 January 2019. IFRS 16 significantly changes lessee accounting but substantially carries forward the lessor accounting requirements in IAS 17. Therefore, there are now significant differences between full IFRS Standard (IFRS 16) and *IFRS for SMEs* Standard (Section 20) notably for operating lease, sale and leaseback transactions and disclosure requirements. The comparison contains reference to IAS 17 because it was in place when the revised *IFRS for SMEs* Standard became effective. The main differences between the requirements of full IFRS Standards (see IAS 17 *Leases*) and the *IFRS for SMEs* Standard (see Section 20 *Leases*) are:

- The *IFRS for SMEs* Standard is drafted in simpler language than that used in full IFRS Standards.
- The following terms are defined in full IFRS Standards but not in the *IFRS for SMEs* Standard:
    - non-cancellable lease;
    - inception of the lease;
    - commencement of the lease term;
    - lease term;
    - economic life;
    - useful life (in the context of leased asset);
    - guaranteed residual value;
    - unguaranteed residual value; and
    - contingent rent.
- When the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases the *IFRS for SMEs* Standard does not require a lessee or lessor to recognise lease payments under operating leases on a straight-line basis (see paragraph 20.15(b)). Full IFRS has no equivalent exception to the straight-line basis.
- Full IFRS Standards provide guidance on how to treat provision in lease agreement to adjust the lease payments for changes in the construction or acquisition cost of the leased property or for changes in some other measure of cost or value, such as general price levels. The *IFRS for SMEs* Standard does not include corresponding guidance.
- Full IFRS Standards state that the definition of a lease includes hire purchase contracts. The *IFRS for SMEs* Standard is silent on this.
- When a lease includes both land and buildings elements full IFRS Standards require each element to be assessed separately and also provide detailed guidance on measurement, for example how to split the minimum lease payments between the land and the building elements. The *IFRS for SMEs* Standard does not address this issue.
- Full IFRS Standards (see SIC Interpretation 15 *Operating Leases-Incentives*) provide guidance on how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor in. The *IFRS for SMEs* Standard is silent on this issue.
- While disclosure requirements in the financial statements of lessors for both finance and operating leases are the same under both full IFRS Standards and *IFRS for SMEs* Standard, there some minor differences for disclosure requirements in the financial statements of lessees. For example, in the financial statements of lessees for finance leases full

IFRS Standards require disclosure of contingent rents recognised as an expense in the period and total of future minimum sublease payments expected to be received under non-cancellable subleases at the end of the reporting period. These are not required to be disclosed under the *IFRS for SMEs* Standard. In addition, under full IFRS both lessors and lessee are required also required to meet the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* in addition to the requirements in IAS 17 *Leases*. There is no such requirement under the *IFRS for SMEs* Standard as there is no equivalent to IFRS 7 *Financial Instruments: Disclosures* under the SME Standard.

- In sale and lease back transactions, for operating leases if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately. There is no such requirement under the *IFRS for SMEs* Standard.

Module 20—Leases

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting leases applying the *IFRS for SMEs* Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those set out beneath it.

Question 1

Which of the following arrangements is accounted for in accordance with the requirements of Section 20?

☐ (a) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

☐ (b) agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.

☐ (c) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources.

☐ (d) leases that could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to changes in the price of the leased asset.

Question 2

An entity entered, as lessee, into a five-day non-cancellable lease of a motor vehicle that has an economic life of five years and nil residual value. Lease payments are CU180 per day. At the end of the lease term the lessee returns the motor vehicle to the lessor.

The lease is:

☐ (a) accounted for as a finance lease in accordance with Section 20.

☐ (b) accounted for as an operating lease in accordance with Section 20.

☐ (c) not accounted for in accordance with Section 20.

Question 3

Which of the following situation would normally lead to a lease being classified as a finance lease?

☐ (a) at the inception of the lease the present value of the minimum lease payments is substantially lower than the fair value of the leased asset.

☐ (b) the lease term is significantly shorter than the economic life of the asset.

☐ (c) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option become exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

☐ (d) the lease does not transfer ownership of the asset to the lessee by the end of the lease term.

Question 4

An entity entered, as lessee, into a two-year non-cancellable lease over a motor vehicle that has an economic life of five years and nil residual value. At the inception of the lease, the present value of the minimum lease payments approximates the fair value of the motor vehicle. Ownership of the motor vehicle passes to the lessee at the end of the lease term.

Assuming it's not a sale, the lease is:

- ☐ (a) accounted for as a finance lease in accordance with Section 20.
- ☐ (b) accounted for as an operating lease in accordance with Section 20.
- ☐ (c) not accounted for in accordance with Section 20.

Question 5

A lease could be classified as:

- ☐ (a) a finance lease by the lessor and the lessee.
- ☐ (b) an operating lease by the lessor and the lessee.
- ☐ (c) a finance lease by the lessor and an operating lease by the lessee.
- ☐ (d) all of (a)–(c) above.
- ☐ (e) none of (a)–(c) above.

Question 6

A lease transfers ownership of the leased asset from the lessor at the end of the lease term for a variable payment equal to the asset's then fair value.

- ☐ (a) the lessee must classify the lease as a finance lease.
- ☐ (b) the lessee must classify the lease as an operating lease.
- ☐ (c) The classification of the lease depends on other facts and circumstances.

Question 7

At the commencement of the term of a finance lease, how should a lessee recognise its rights to use and obligations in its statement of finance position?

- ☐ (a) At amounts equal to the lower of the fair value of the leased asset and the present value of the minimum lease payments determined at the inception of the lease.
- ☐ (b) At amounts equal to the lower of the fair value of the leased asset and the present value of the minimum lease payments determined at the commencement of the lease term.
- ☐ (c) At amounts equal to the fair value of the leased asset.
- ☐ (d) At amounts equal to the present value of the minimum lease payments.

Question 8

Depreciation of a leased machine is:

☐ (a) recognised by the lessee where the lessor and the lessee have classified the lease as a finance lease.

☐ (b) recognised by the lessor where the lessor and the lessee have classified the lease as an operating lease.

☐ (c) recognised by neither the lessor nor the lessee when the lease is classified as a finance lease by the lessor and an operating lease by the lessee.

☐ (d) all of the above.

Question 9

A lessee paid CU2,000 to a broker for arranging a finance lease. The lessee must account for the broker's fee:

☐ (a) as an expense in the period in which the fee was incurred (ie probably at the inception of the lease).

☐ (b) include the fee in the cost of the leased asset.

☐ (c) defer recognition of the expense and recognise the fee in profit or loss on the straight-line method over the lease term.

Question 10

An entity enters as lessor into a two-year lease in respect of a machine that has a fair value of CU16,000 and an economic life of four years with nil scrap value. The lessee pays rent of CU8,500 per year in advance. The lessee holds an option to acquire the machine for CU1. The option is exercisable at the end of the lease term, when the fair value of the machine (estimated at the inception of the lease) is expected to be CU6,000. The lessor is not a dealer lessor.

At the commencement of the lease term, the lessor would:

☐ (a) recognise a lease receivable of CU16,000.

☐ (b) recognise the carrying amount of the machine subject to the lease as an item of property, plant and equipment.

Question 11

On 1 January 20X0 an entity entered, as lessee, into a 10-year non-cancellable operating lease of a building. The lessee classifies the lease as an operating lease.

In accordance with the lease no amount is payable for the first five years of the lease. The lease payments for years ending 31 December 20X5–20X9 are CU5,000 per year, payable in arrears (ie payable on 31 December each year).

In determining profit or loss for the year ended 31 December 20X0, the lessee would recognise:

☐ (a) CU2,500 lease expense.

☐ (b) nil.

☐ (c) CU5,000.

Question 12

Which of the following statement is **NOT** true in relation to operating leases?

☐ (a) the leased asset is not presented as an asset in the lessor's financial statements.

☐ (b) lease payments is generally recognised on straight-line basis.

☐ (c) the leased asset is not presented as an asset in the lessee's financial statements.

Question 13

On 1 January 20X1 an entity entered into an arrangement to sell a machine to a bank and lease it back for a period of three years. At that time, the main facts about the machine and the lease were:

- selling price = CU200,000
- carrying amount = CU70,000
- fair value = CU200,000
- remaining economic life = three years
- residual value = nil
- lease payments = CU77,606 per year (payable in arrears on 31 December each year).
- interest rate implicit in the lease = 8% per year.

In accounting for the arrangement, the seller-lessee would recognise in the determination of its profit or loss for the year ended 31 December 20X1:

☐ (a) income of CU130,000 (gain on sale of machine) and expense of CU77,606 (lease expense).

☐ (b) expenses of CU23,333 (depreciation) and CU16,000 (finance cost) (and no income).

☐ (c) income of CU43,333 (amortised deferred gain on sale of machine) and expenses of CU23,333 (depreciation) and CU16,000 (finance cost).

☐ (d) income of CU43,333 (amortised deferred gain on sale of machine) and expenses of CU66,667 (depreciation) and CU16,000 (finance cost).

Question 14

The facts are the same as in question 13. However, in this question, the remaining economic life of the machine is 30 years and the lease rent is CU23,000 per year of the three-year lease term.

In accounting for the arrangement, the seller-lessee would recognise in the determination of its profit or loss for the year ended 31 December 20X1:

☐ (a) income of CU130,000 (gain on sale of machine) and expense of CU23,000 (lease expense).

☐ (b) expenses of CU23,333 (depreciation) and CU16,000 (finance cost) (and no income).

☐ (c) income of CU43,333 (amortised deferred gain on sale of machine) and expenses of CU2,333 (depreciation) and CU16,000 (finance cost).

☐ (d) income of CU43,333 (amortised deferred gain on sale of machine) and expenses of CU66,667 (depreciation) and CU16,000 (finance cost).

Question 15

Which of the following is a lessee required to disclose for finance leases?

- ☐ (a) contingent rents recognised as an expense in the period.
- ☐ (b) the net carrying amount at the end of the reporting period for each class of asset.
- ☐ (c) the nature of the lessee's leasing activities.
- ☐ (d) All of the above.
- ☐ (e) none of the above.

Module 20—Leases

Answers

Q1 (b) In accordance with paragraph 20.1 answers (a), (c) and (d) are excluded from the scope of Section 20.

Q2 (b) The lessor retains significant risks and rewards incidental to ownership of the motor vehicle (eg the expectation of profitable operation over the motor vehicle (and the risk of losses from idle capacity) after the lease term and of gain or loss from change in the fair value of a motor vehicle) (see paragraphs 20.4–20.8).

Q3 (c) see paragraph 20.5.

Q4 (a) The lease transfers substantially all the risks and rewards incidental to ownership of the motor vehicle from the lessor to the lessee (eg the risk of losses from idle capacity and of gain or loss from change in the fair value of a motor vehicle) (see paragraphs 20.4–20.8).

Q5 (d) The principle of lease classification is the same for the lessor and the lessee—does the lease transfer substantially all the risks and rewards incidental to ownership of the leased asset? (see paragraph 20.4). However, the application of the principle to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

Q6 (c) Does the lease transfer substantially all the risks and rewards incidental to ownership of the leased asset? If so, the lease is a finance lease. If not, it is an operating lease. It is possible to envisage circumstances in which either classification would be appropriate. For example:

- The lease is a finance lease if at inception the fair value of the leased asset is expected to be nil at the end of the lease term—in this case the lessor's interest in the residual value of the leased asset is so small that the lessor does not retain significant risks and rewards incidental to ownership of the leased asset.
- The lease is an operating lease if at inception the fair value of the leased asset is expected to be significant at the end of the lease term—in this case the lessor has retained a significant interest in the residual value of the leased asset (ie the lease does not transfer substantially all the risks and rewards incidental to ownership of the leased asset).

Q7 (a) see paragraph 20.9.

Q8 (d) The lease classification set out in answer 6(c) may arise when, for example, the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

Q9 (b) Any initial direct costs of the lessee (incremental costs that are directly attributable to negotiating and arranging a lease) are added to the amount recognised as an asset (see paragraph 20.9).

Q10 (a) The lease is a finance lease—viewed from the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership of the leased asset from the lessor to the lessee. This is evidenced by the pricing of the purchase option (at CU1) making it reasonably certain that the lessee will exercise its option to acquire the leased asset, which at the end of the lease term will be only halfway through its expected economic life (see paragraph 20.5 for classification and 20.17 for initial recognition and measurement).

Q11 (a) Calculation: CU5,000 lease payments × 5 years = CU25,000 total lease payments over the lease term. CU25,000 ÷ 10 years = CU2,500 operating lease expense per year.

Q12 (a) see paragraph 20.24.

Q13 (d) The arrangement is a sale and finance-leaseback transaction because the lease term is for the entire remaining economic life of the asset. In accordance with paragraph 20.33 the seller-lessee must defer the CU130,000 gain and amortise it over the three-year lease term (calculation CU130,000 excess ÷ 3 years = CU43,333 per year). The leased asset is depreciated over its useful life (calculation: CU200,000 ÷ 3 years = CU66,667). Finance cost is CU16,000 (calculation 8% × CU200,000 received from the bank).

Q14 (a) The arrangement is a sale and operating-leaseback transaction (ie the lease term is significantly shorter than the economic life of the asset) and the proceeds are equal to the fair value of the machine. In accordance with paragraph 20.34 the seller-lessee must recognise the CU130,000 gain on disposal immediately. In accordance with paragraph 20.15 the lease payments are recognised at CU23,000 per year.

Q15 (b) see paragraph 20.13

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting leases applying the *IFRS for SMEs* Standard by completing the case studies provided.

Once you have completed a case study, check your answers against those set out beneath it.

Case study 1

On 1 March 20X1 SME A entered, as lessee, into a lease to acquire a second-hand motor vehicle. The fair value (selling price) of the car is CU24,000.

The lease term is 36 months and the interest rate implicit in the lease is 0.75% per month. At the end of the lease term the ownership of the motor vehicle is automatically transferred to the lessee.

The lease schedule appended to the lease agreement is set out in the Appendix.

The useful life of the motor vehicle is four years with nil residual value. SME A depreciates motor vehicles on the straight-line basis.

Draft an extract showing how the lease could be presented in the financial statements of SME A for the year ended 31 December 20X2.

Appendix to case study 1

Lease schedule

Period	*Date*	*Interest payment CU*	*Principal payment CU*	*Total payment CU*	*Balance to be paid CU*
0	01-Mar-X1	–	–	–	24,000.00
1	31-Mar-X1	180.00	583.19	763.19	23,416.81
2	30-Apr-X1	175.63	587.57	763.19	22,829.24
3	31-May-X1	171.22	591.97	763.19	22,237.26
4	30-Jun-X1	166.78	596.41	763.19	21,640.85
5	31-Jul-X1	162.31	600.89	763.19	21,039.96
6	31-Aug-X1	157.80	605.39	763.19	20,434.57
7	30-Sep-X1	153.26	609.93	763.19	19,824.64
8	31-Oct-X1	148.68	614.51	763.19	19,210.13
9	30-Nov-X1	144.08	619.12	763.19	18,591.01
10	**31-Dec-X1**	**139.43**	**623.76**	**763.19**	**17,967.25**
11	31-Jan-X2	134.75	628.44	763.19	17,338.81
12	28-Feb-X2	130.04	633.15	763.19	16,705.66
13	31-Mar-X2	125.29	637.90	763.19	16,067.75
14	30-Apr-X2	120.51	642.69	763.19	15,425.07
15	31-May-X2	115.69	647.51	763.19	14,777.56
16	30-Jun-X2	110.83	652.36	763.19	14,125.20
17	31-Jul-X2	105.94	657.25	763.19	13,467.95
18	31-Aug-X2	101.01	662.18	763.19	12,805.76
19	30-Sep-X2	96.04	667.15	763.19	12,138.61
20	31-Oct-X2	91.04	672.15	763.19	11,466.46
21	30-Nov-X2	86.00	677.20	763.19	10,789.26
22	**31-Dec-X2**	**80.92**	**682.27**	**763.19**	**10,106.99**
23	31-Jan-X3	75.80	687.39	763.19	9,419.60
24	28-Feb-X3	70.65	692.55	763.19	8,727.05
25	31-Mar-X3	65.45	697.74	763.19	8,029.31
26	30-Apr-X3	60.22	702.97	763.19	7,326.34
27	31-May-X3	54.95	708.25	763.19	6,618.09
28	30-Jun-X3	49.64	713.56	763.19	5,904.53
29	31-Jul-X3	44.28	718.91	763.19	5,185.62
30	31-Aug-X3	38.89	724.30	763.19	4,461.32
31	30-Sep-X3	33.46	729.73	763.19	3,731.59
32	31-Oct-X3	27.99	735.21	763.19	2,996.38
33	30-Nov-X3	22.47	740.72	763.19	2,255.66
34	**31-Dec-X3**	**16.92**	**746.28**	**763.19**	**1,509.39**
35	31-Jan-X4	11.32	751.87	763.19	757.51
36	28-Feb-X4	5.68	757.51	763.19	0.00

Answer to case study 1

[Extract from] SME A statement of financial position at 31 December 20X2

	Note	*20X2*	*20X1*
ASSETS			
Non-current assets			
Property, plant and equipment	8	CU13,000	CU19,000
…			
EQUITY AND LIABILITIES			
Non-current liabilities			
Long-term borrowings	12	CU1,509	CU10,107
…			
Current liabilities			
Current portion of long-term borrowings	12	CU8,598	CU7,860
…			

[Extract from] SME A statement of comprehensive income at 31 December 20X2

	Note	*20X2*	*20X1*
…			
Finance costs		(1,298) (g)	(1,599) (h)
…			

[Extract from] SME A statement of cash flows at 31 December 20X2

	Note	*20X2*	*20X1*
Cash flows from operating activities			
Interest paid		(1,298) (g)	(1,599) (h)
…			
Cash flows from financing activities			
Payment of finance lease liabilities		(7,860) (i)	(6,033) (j)
…			

[Extract from] SME A notes for the year ended 31 December 20X2

Note 1 Accounting policies

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership of the leased asset to the Group. All other leases are classified as operating leases.

Rights to assets held under finance leases are recognised as assets of the Group at the fair value of the leased property (or, if lower, the present value of minimum lease payments) at the inception of the lease. The corresponding liability to the lessor is included in the statement of financial position as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are deducted in measuring profit or loss. Assets held under finance leases are included in property, plant and equipment, and depreciated and assessed for impairment losses in the same way as owned assets.

Rentals payable under operating leases are charged to profit or loss on a straight-line basis over the term of the relevant lease.

Property, plant and equipment

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

Depreciation is charged so as to allocate the cost of the assets less their residual values over their estimated useful lives, using the straight-line method. Motor vehicles are depreciated at the rate of 25% per year.

If there is an indication that there has been a significant change in depreciation rate, useful life or residual value of an asset, the depreciation of that asset is revised prospectively to reflect the new expectations.

Note 8 Property, plant and equipment

Motor vehicles	*20X2*		*20X1**	
	CU		*CU*	
1 January				
Cost	24,000		–	
Accumulated depreciation	(5,000)		–	
Carrying amount	19,000		–	
Additions	-		24,000	(a)
Depreciation	(6,000)	(b)	(5,000)	(a)
31 December	13,000		19,000	
Analysed as follows:				
Cost	24,000		24,000	
Accumulated depreciation	(11,000)	(p)	(5,000)	
Carrying amount	13,000		19,000	

*Note: The entity need not provide the comparative figures presented in this reconciliation (see paragraphs 20.14 and 17.31(e)). In this example the entity has voluntarily provided the comparative information.

Note 12 Long-term borrowings

Obligations under finance leases

The entity holds a motor vehicle with an estimated useful life of four years under a three-year finance lease. The future minimum lease payments are as follows: (k)

	20X2		*20X1*	
	CU		*CU*	
Future lease payments				
within 12 months	9,158		9,158	
after one year but before five years	1,526		10,685	
after five years	–		–	
Total	10,684		19,842	
Future finance costs	(577)	(l)	(1,875)	(m)
Lease liability	10,107		17,967	
The obligation is classified as:				
Current portion	8,598	(e)	7,860	(f)
Long term portion	1,509	(c)	10,107	(d)
Total lease liability	10,107		17,967	

There is no contingent rent.

The lease liabilities are secured on the related machinery (see note 8).

The calculations and explanatory notes below do not form part of the answer to this case study:

(a)

	CU
Fair value	23,010
Initial direct costs (see paragraph 20.9)	990
Cost of motor vehicle	24,000

Depreciation = CU24,000 ÷ 48 months useful life = CU500 per month

Depreciation expense for 20X1: CU500 × 10 months (ie March 20X1 to December 20X1) = CU5,000

(b) Depreciation expense for 20X2: CU500 × 12 months (January-December 20X2) = CU6,000

Accumulated depreciation for 20X2: CU500 × 22 months (ie March 20X1−December 20X2) = CU11,000.

(c) Capital repayable after 31 December 20X3 (ie CU1,509.39 from Appendix).

(d) Capital repayable after 31 December 20X2 (ie CU10,106.99 from Appendix).

(e) CU10,106.99 capital on 31 December 20X1 less CU1,509.39 capital repayable after 31 December 20X2 (see Appendix).

(f) CU17,967.25 capital on 31 December 20X1 less CU10,106.99 capital repayable after 31 December 20X2 (see Appendix).

(g) CU134.75 (see interest column in Appendix) + CU130.04 + CU125.29 + CU120.51 + CU115.69 + CU110.83 + CU105.94 + CU101.01 + CU96.04 + CU91.04 + CU86.00 + CU80.92 = CU1,298.06.

(h) CU180.00 (see interest column in Appendix) + CU175.63 + CU171.22 + CU166.78 + CU162.31 + CU157.80 + CU153.26 + CU148.68 + CU144.08 + CU139.43 = CU1,599.

(k) CU763.19 lease payments x 12 months (January−December 20X2) = CU9,158.28. CU9,158.28 less CU1,298.06 interest (see (g) above) = CU7,860.22 capital repayments.

(l) CU763.19 lease payments x 10 months (March−December 20X1) = CU7,631.90. CU7,631.90 less CU1,599 interest (see (h) above) = CU6,032.90 capital repayments.

(k)

	20X2		*20X1*	
	Computation	*CU*	*Computation*	*CU*
Future lease payments				
within 12 months	CU763.19 x 12 months (Jan X3 – Dec X3)	9,158	CU763.19 x 12 months (Jan - Dec)	9,158
after one year but before five years	CU763.19 x 2 months (Jan & Feb X3)	1,526	CU763.19 x 14 months (Jan X2−Feb X3)	10,685
after five years		–		–
Total	CU763.19 x 14 months (Jan X3 - Feb X4)	10,684	CU763.19 x 26 months (Jan X2 - Feb X4)	19,842

(l) Jan X3 – Feb X4: CU75.80 (see interest column in Appendix) + CU70.65 + CU65.45 + CU60.22 + CU54.95 + CU49.64 + CU44.28 + CU38.89 + CU33.46 + CU27.99 + CU22.47 + CU16.92 + CU11.32 + CU5.68 = CU577.72.

(m) Jan X2 – Feb X4: CU134.75 (see interest column in Appendix) + CU130.04 + CU125.29 + CU120.51 + CU115.69 + CU110.83 + CU105.94 + CU101.01 + CU96.04 + CU91.04 + CU86.00 + CU80.92 + CU75.80 + CU70.65 + CU65.45 + CU60.22 + CU54..95 + CU49.64 + CU44.28 + CU38.89 + CU33.46 + CU27.99 + CU22.47 + CU16.92 + CU11.32 + CU5.68 = CU1,875.78.

Case study 2

In 20X1 SME B entered, as lessee, into the following lease arrangements:

Lease 1

On 1 January 20X1 SME B entered into an arrangement to sell a factory building to a bank and lease it back for a period of 30 years. At that time the main facts about the building and the lease were:

- selling price = CU500,000
- carrying amount = CU150,000
- fair value = CU500,000
- remaining economic life = 30 years
- SME B intends to use the asset for its entire economic life
- residual value = nil
- lease payments = CU44,414 per year (payable in arrears on 31 December each year).
- interest rate implicit in the lease = 8% per year.

Lease 2

On 1 January 20X1 SME B entered into a lease to acquire a machine. At that time the main facts about the machine and the lease were:

- fair value = CU100,000
- economic life = 10 years
- SME B intends to use the asset for its entire economic life
- residual value = nil
- initial lease term = five years
- lessee has option to renew the lease for a further five-year lease term
- lease payments—initial term = CU23,190 per year (payable in advance on 1 January each year)
- lease payments—renewal period = CU1 per year (payable in advance on 1 January each year)
- interest rate implicit in the lease = 8% per year.

Lease 3

On 1 January 20X1 SME B entered into a lease agreement for the use of an administration building for a period of nine years. At that time the main facts about the building and the lease were:

- fair value = CU250,000
- remaining economic life = 50 years
- lease payments 20X1–20X5 = nil
- lease payments 20X6–20X9 = CU59,000 per year (payable in advance on 1 January of each year).

Lease 4

On 30 June 20X1 SME B entered into an arrangement to sell the building occupied by its sales staff to a bank and lease it back for a period for a period of two years. At that time the main facts about the building and the lease are:

- selling price = CU50,000
- carrying amount = CU45,000
- fair value = CU50,000
- remaining economic life = five years
- lease payments = CU12,700 per year (payable in arrears on 1 July each year).

Prepare accounting entries to record the leases in the accounting records of SME B for the year ended 31 December 20X1.

Answer to case study 2

Lease 1

1 January 20X1

Dr	Cash	CU500,000	
	Cr Property, plant and equipment—building		CU150,000
	Cr Deferred gain		CU350,000

To recognise the sale of the factory building.

Dr	Property, plant and equipment—leased building	CU500,000	
	Cr Finance lease liability		CU500,000

To recognise the finance lease.

31 December 20X1

Dr	Profit or loss—finance cost	CU40,000[(a)]	
Dr	Finance lease liability	CU4,414	
	Cr Cash		CU44,414

To apportion the minimum lease payment between the finance charge for the year ended 31 December 20X1 and the reduction of the outstanding liability on 31 December 20X1.

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	CU16,667[(b)]	
	Cr Property, plant and equipment—leased building		CU16,667

To recognise the depreciation of the leased factory building for the year ended 31 December 20X1.

Dr	Deferred gain amortised	CU11,667[(c)]	
	Cr Profit or loss—deferred gain amortised		CU11,667

To recognise the amortisation of the deferred gain for the year ended 31 December 20X1.

Lease 2

1 January 20X1

Dr	Property, plant and equipment—leased machine	CU100,000	
	Cr Finance lease liability		CU100,000

To recognise the finance lease.

Dr	Finance lease liability	CU23,190	
	Cr Cash		CU23,190

To recognise the minimum lease payment.

31 December 20X1

Dr	Profit or loss—finance cost	CU6,145[d]	
	Cr Finance lease liability		CU6,145

To recognise the finance charge for the year ended 31 December 20X1.

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset ie capitalised as inventory)	CU10,000[e]	
	Cr Property, plant and equipment—building		10,000

To recognise the depreciation of the leased machine for the year ended 31 December 20X1.

Lease 3

31 December 20X1

Dr	Profit or loss—operating lease expense	CU26,222[f]	
	Cr Liability—accrued operating lease expense		CU26,222

To recognise the accrual of the operating lease expense for the use of the leased administration building.

Lease 4

30 June 20X1

Dr	Cash	CU50,000	
	Cr Property, plant and equipment—building		CU45,000
	Cr Profit or loss—gain on disposal of building		CU5,000

To recognise the sale of the building.

31 December 20X1

Dr	Profit or loss—operating lease expense	CU6,350[g]	
	Cr Cash		CU6,350

To recognise the accrual of the operating lease expense for the use of the leased building.

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) CU500,000 × 8% = CU40,000.

(b) CU500,000 ÷ 30 years = CU16,667.

(c) CU350,000 deferred gain ÷ 30 years = CU11,667.

(d) (CU100,000 on initial recognition less CU23,190 paid on 1 January 20X1) × 8% = CU6,145.

(e) CU100,000 ÷ 10 years = CU10,000. The useful life of the machine is 10 years because it is reasonably certain that the lessee will renew the lease at the end of the initial lease term.

(f) CU59,000 × 4 years = CU236,000 ÷ 9-year lease term = CU26,222 operating lease expense per year.

(g) CU12,700 × 6 ÷ 12 months = CU6,350.