Chapter 21

LEASES (IAS-17)

Objectives

The objective of this IAS is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

Scope

This Standard shall be applied in accounting for all leases other than:

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

b) Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, this Standard shall not be applied as the basis of measurement for:

a) property held by lessees that is accounted for as investment property (see IAS 40 Investment Property);

b) investment property provided by lessors under operating leases (see IAS 40);

c) biological assets held by lessees under finance lease (see IAS 41 Agriculture); or

d) biological assets provided by lessors under operating leases (see IAS 41)

Definitions

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

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease

A non-cancelable lease is a lease that is cancelable only:

a) upon the occurrence of some remote contingency;

b) with the permission of the lessor;

c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

a) a lease is classified as either an operating or a finance lease; and

b) in the case of a finance lease, the amounts to be recognized at the commencement of the lease term are determined.

The commencement of the lease term is 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).

The lease term is the non-cancelable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Minimum lease payments are 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:

a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

b) 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.

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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Economic life is either:

a) the period over which an asset is expected to be economically usable by one or more users; or

b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Un-guaranteed residual value is that portion of the residual value of the leased asset, the realization of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

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 un-guaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

a) the gross investment in the lease, and

b) the net investment in the lease

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 and (b) the un-guaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct cost of the lessor.

The lessee's incremental borrowing rate of interest is 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.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (eg percentage of future sales, amount of future use, future use, future price indices, future market rate of interest).

Classification of Leases

- The classification of lease is based on the extent to which risk (possibility of losses from idle capacity or technological obsolescence) and rewards (variation in rewards) incident to ownership lie with the lessor or the lessee.
- 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.
- Examples of situations that individually or in combination would normally lead to 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 substantially lower than the fair value at the date the option becomes exercisable and it is reasonably certain that the option will be exercised;
    c) the lease term is for a 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 minimum lease payments amounts to at lease substantially all the fair value of the leased asset; and
    e) the leased assets are of such a specialized nature that only the lessee can use then without major modification
- Further examples that could also lead to a lease being classified as a finance lease: -
    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 fair value of the residual accrue to the lessee; 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
- Leases of land and building are classified as operating or finance leases like leases of other assets.
- The land and building elements of a lease of land and building are considered separately for the purpose of lease classification and the minimum lease payments are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interest in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the

entire lease is classified as a finance lease, unless it is clear that both elements are operating leases. If the land element of the lease is immaterial then the whole lease will be classified on the basis of lease of building. Separate measurement of the land and building elements is not required when the lessee's interest in both land and building is classified as an investment property and fair value model is used (IAS –40).

Leases in the financial Statement of Lessees

Finance Leases

Initial Recognition

At the commencement of the lease term, lessees shall recognize finance leases as assets and liabilities in their 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, each determined at the inception of the lease. 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 is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognized as an asset.

Subsequent Measurement

- Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.
- Finance lease gives rise to depreciation expenses for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognized shall be calculated in accordance with IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets. 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.
- Lessees shall, in addition to meeting the requirements of IFRS 7 Financial Instruments: Disclosure and Presentation, make the following disclosures for finance leases:
    a) For each class of asset, the net carrying amount at the statement of financial position date.
    b) Reconciliation between the total of future minimum lease payments at the statement of financial position date, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the statement of financial position date, and their present value, for each of the following periods:
        i) Not later than one year;
        ii) Later than one year and not later than five years;
        iii) Later than five years.
    c) Contingent rents recognized as an expense in the period.

d) The total of future minimum sub-lease payments expected to be received under non-cancelable sub-leases at the statement of financial position date.

e) A general description of the lessee's material leasing arrangements including, but not limited to, the following:

   i) the basis on which contingent rent payable is determined;

   ii) the existence and terms of renewal or purchase options and escalation clauses; and

   iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Operating Leases

- Lease payments under an operating lease shall be recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.
- Lessees shall, in addition to meeting the requirements of IFRS 7, make the following disclosures for operating leases:

  a) the total of future minimum lease payments under non-cancelable 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;

     iii) later than five years.

  b) The total of future minimum sublease payments expected to be received under non-cancelable subleases at the statement of financial position date.

  c) Lease and sublease payments recognized as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

  d) A general description of the lessee's significant leasing arrangements including, but not limited to, the following:

     i) the basis on which contingent rent payable is determined;

     ii) the existence and terms of renewal or purchase options and escalation clauses; and

     iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt and further leasing.

Leases in Financial Statements of Lessors

Finance Leases

Initial Recognition

Lessors shall recognize assets held under a finance lease in their statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Subsequent Measurement

- 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.
- Manufacturer or dealer lessor shall recognize selling profit or loss in the period, in accordance with the policy followed by the entity for outright

sales. 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 recognized as an expense when the selling profit is recognized.

Manufacturer 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 incomes: -

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 an applicable volume or trade discounts; and

b) finance income over the lease term

- Lessors shall, in addition to meeting the requirements in IFRS 7, disclose the following for finance leases:

  a) a reconciliation between the gross investment in the lease at the statement of financial position date, and the present value of minimum lease payments receivable at the statement of financial position date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the statement of financial position date, for each of the following periods:

     i) not later than one year;

     ii) later than one year and later than five years;

     iii) later than five years.

  b) Unearned finance income

  c) The un-guaranteed residual values accruing to the benefit of the lessor

  d) The accumulated allowance for un-collectible minimum lease payments receivable

  e) Contingent rents recognized as income in the period

  f) A general description of the lessor's material leasing arrangements

Operating Leases

- Lessors shall present assets subject to operating lease in their statement of financial position according to the nature of the asset.
- Lease income from operating leases shall be recognized in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.
- Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis as the lease income.
- The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with IAS 16 and IAS 38.
- Lessors shall, in addition to meeting the requirements of IFRS 7, disclose the following for operating leases:

a) the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:
    i) not later than one year;
    ii) later than one year and not later than five years;
    iii) later than five years.

b) Total contingent rents recognized as income in the period.

c) A general description of the lessor's leading arrangements.

Sale and Leaseback Transactions

- If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognized as income by a seller-lessee. Instead, it shall be deferred and amortized over the lease term.
- If a sale and leaseback transaction is an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognized immediately. If the sale price is below fair value, any profit or loss shall be recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortized 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 excess over fair value shall be deferred and amortized over the period for which the asset is expected to be used.
- 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 recognized immediately.

Q-1

The lease is initiated on 1/1/05 for equipment with an expected useful life of 3 years. The equipment reverts back to the lessor on expiration of the lease agreement.

1. The FMV of the equipment is Rs. 135,000.
2. Three payments are due to the lessor in the amount of Rs. 50,000 per year beginning 12/31/05. An additional sum of Rs. 1,000 is to be paid annually by the lessee for insurance.
3. Lessee guarantees a Rs. 10,000 residual value on 12/31/07 to the lessor.
4. Irrespective of the Rs. 10,000 residual value guarantee, the leased asset is expected to have only a Rs.1,000 salvage value on 12/31/07.
5. The lessee's incremental borrowing rate is 10% (lessor's implicit rate is unknown).

Required:

1. Annuity Factor and Present Value of Minimum Lease Payments
2. Repayment Schedule
3. Prepare accounts for

- Lease Liability
- Leased Asset
- Accumulated Depreciation
- Interest

Q-2

Accounting for a finance lease, asset ownership transferred to lessee and fair market value of leased asset lower than present value of minimum lease payments.

1. A 3-year lease is initiated on 1/1/05 for equipment with an expected useful life of 5 years.
2. Three annual lease payments of Rs. 52,000 are required beginning on 1/1/05 (note that the payment at the beginning of the year changes the PV computation). The lessor pays Rs. 2,000 per year for insurance on the equipment.
3. The lessee can exercise a bargain purchase option on 12/31/07 for Rs. 10,000. The expected residual value at 12/31/08 is Rs. 1,000.
4. The lessee's incremental borrowing rate is 10% (lessor's implicit rate is unknown).
5. The fair market value of the property leased is Rs. 140,000.

Required:

1. Present Value of Minimum Lease Payments
2. Interest Rate (by Trial and Error Method)
3. Repayment Schedule
4. Prepare Accounts for :
    - Interest
    - Leased Liability

Q-3

XYZ Inc. is a manufacturer of specialized equipment. Many of its customers do not have the necessary funds or financing available for outright purchase. Because of this XYZ offers a leasing alternative. The data relative to a typical lease are as follows:

1. The non-cancelable fixed portion of the lease term is 5 years. The lessee has the option to renew the lease for an additional 3 years at the same rental. The estimated useful life of the asset is 10 years. Lessee guarantees a residual value of Rs. 40,000 at the end of 5 years, but the guarantee lapses if the full 3 renewal periods are exercised.
2. The lessor is to receive equal annual payments over the term of the lease. The leased property reverts back to the lessor on termination of the lease.
3. The lease is initiated on 1/1/05. Payments are due on 12/31 for the duration of the lease term.
4. The cost of the equipment to XYZ. Inc. is Rs. 100,000. The lessee incurs cost associated with the inception of the lease in the amount of Rs. 2,500.
5. The selling price of the equipment for an outright purchase is Rs. 150,000.
6. The equipment is expected to have a residual value of Rs. 15,000 at the end of 5 years and Rs. 10,000 at the end of 8 years.
7. The lessor desires a return of 12% (the implicit rate).

Required:

a) MLPs.
b) Identify the kind of lease.
c) Gross Investment
d) Cost of Goods Sold
e) Adjusted Selling Price
f) Unearned Finance Income
g) Entries to record the Lease in the lessor's books at it's inception and the end of the first year of lease.

Q-4

Emirates Refining needs new equipment to expand its manufacturing operation; however, it does not have sufficient capital to purchase the asset at this time. Because of this, Emirates Refining has employed Consolidated Leasing to purchase the asset. In turn, Emirates will lease the asset from Consolidated. The following information applies to the terms of the lease:

1. A 3-year lease is initiated 1/1/05 for equipment costing Rs. 131,858, with an expected useful life of 5 years. FMV at 1/1/05 of equipment is Rs. 131,858.
2. Three annual payments are due to the lessor beginning 12/31/05. The property reverts back to the lessor on termination of the lease.
3. The un-guaranteed residual value at the end of year 3 is estimated to be Rs. 10,000.
4. The annual payment are calculated to give the lessor a 10% return (the implicit rate).
5. The lease payments and un-guaranteed residual value have a PV equal to Rs. 131,858 (FMV of asset) at the stipulated discount rate.
6. The initial direct cost of the lessor is Rs. 7,500.

Required:

a) The annual payment
b) Unearned Finance Income and Net Investment in the Lease
c) Amortization Schedule
d) The entry made initially to record the Lease
e) Using the amortization schedule made above, the entries that would be made in each of the indicated years

PAST PAPERS

Q.1

(a) A lessee enters a leasing arrangement on 31 December 20X3 for a piece of equipment costing Rs.47,460. The lease requires the payment of an annual rental of Rs. 13,610 payable in advance. The primary period of the lease is four years. After the end of primary period, the lessee has the right to extend the lease indefinitely on payment of a nominal annual rental. The lessee believes that the equipment will last for four years and will have no scrap value at the end of that period. The lessee depreciates assets of this type using the straight line basis. Both the lessor and the lessee have accounting periods ending on 31 December.

(i) Calculate the IRR of the lease.

(ii) Prepare the note of "Debtors" as it would appear in the accounts of the lessor. **(10)**

(b) State the disclosure requirements for Lessees in case of operating leases in accordance with IAS – 17. **(05)**

Q.2

(a) An enterprise agrees to enter into a new lease agreement with a new lessor. The lessor agrees to a rent free period for the first three years as incentive to the lessee for entering into the new lease. The new lease has a term of 20 years, at a fixed rent of Rs.200,000 per year from year 4 to 20. Determine the amount of expense to be charged by the lessee for the first three years and the remaining 17 years. What amount would the lessor recognize as income from year 1 to year 20? **(05)**

(b) Give disclosure requirements for the 'Discontinued Operation' under IFRS 5. (**05)**

(c) Discuss the implication of change in accounting policy in interim financial reporting requirements. **(05)**

Q.3

DJ Products deals in large office machines. It also offers such machines on lease.

One such machine was leased to a customer on July 1, 2004. Its particulars are as follows:

Purchase cost of DJ Products	Rs. 150,000
Useful life	8 years
Lease period	6 years
Unguaranteed residual value	Rs. 10,000
Annual rental payable at beginning of each year	Rs. 36,500

The customer's incremental borrowing rate is 10% whereas the discounting rate implicit in the lease is 8%.
The present values of a single payment of Re.1 and the present values of annuities of Re.1 received at the end of the year are as follows:

Present value of Re.1

Year	**Single payment**		**Annuities**	
	8%	**10%**	**8%**	**10%**
1	0.926	0.910	0.926	0.910
2	0.857	0.826	1.783	1.736
3	0.794	0.751	2.577	2.487
4	0.735	0.683	3.312	3.170
5	0.681	0.621	3.993	3.791
6	0.630	0.564	4.623	4.355
7	0.583	0.513	5.206	4.868
8	0.540	0.467	5.747	5.335

Required:

(a) Compute the following for DJ Products as at July 1, 2004:
 (i) Gross investment in the lease;
 (ii) Unearned finance income.

(b) Extracts of profit and loss account and balance sheet including notes thereon, as at June 30, 2005 including all necessary disclosures as required under IAS-17. **(16)**

Q.4

Taqi Limited has obtained a fleet of Trucks and Busses under a three years lease contract from Faraz Leasing Company Limited. Total cost of assets is Rs. 75 million and the expected economic life is considered to be 15 years. Lease rentals of Rs. 12 million per annum shall be paid at the end of each year. The market rate of return is 10%.
It has been agreed that Taqi Limited will return the assets at the end of the lease term. According to the terms of the contract, Taqi Limited is required to deposit cash equivalent to 20% of the total cost of the fleet before taking delivery of assets. The deposit does not carry any return and will be refunded in full at the end of the lease term.

Required:

(a) Comment on the accounting treatment of the above arrangement, from the lessee's point of view.

(b) Prepare accounting entries in the books of the lessee at the inception of lease and at the end of each year. **(14)**

Q.5

Auto Construction Pakistan Limited (ACPL) is engaged in the business of renting of construction machinery.

On March 15, 2009 ACPL negotiated and finalised an agreement for purchase of used machinery from Malaysia. The price on FOB basis was agreed at US$ 0.4 million. The machinery was loaded on the ship on April 1, 2009 and arrived at the company premises on May 31, 2009. According to the agreement a down payment of 10% was made on the date of loading. The remaining amount was paid on June 30, 2009. The US$ conversion rates on April 1, May 31 and June 30 were Rs. 80.90, Rs. 81.60 and Rs. 82.70 respectively. A cost of Rs. 4 million was incurred on freight, taxes and other charges.

Economic life of the machinery is 10 years.

On July 1, 2009, ACPL sold the machinery to Smart Investment Limited for Rs. 40 million and leased it back under the following arrangement:

(i) Lease term of 5 years commencing from July 1, 2009.

(ii) 10 half yearly installments of Rs. 5.50 million each payable in arrears.

(iii) Interest rate implicit in the lease at 12.506% On July 1, 2009 ACPL rented the machinery to a customer for three years at a half yearly rent of Rs. 5 million each, payable in advance with 5% annual increase.

Required:

Prepare notes to the financial statements for the year ended December 31, 2009 in accordance with the requirement of IAS 17 (Leases). **(13)**

Q.6

Hi-Tech Pakistan Limited (HPL) is a public limited company and deals in medical equipments. On 1 October 2009 HPL had introduced a Robotic Surgery System for the first time in Pakistan.

In November 2009, HPL had launched a country wide sales promotion campaign to introduce the system in various hospitals at a cost of Rs. 16 million whereas expenditure on training of the technical staff amounted to Rs. 12 million.

On 1 April 2010 HPL signed a lease agreement with Comforts Hospital for sale and 3-year maintenance of the system. The terms of the agreement are as under:

Lease period	3 years
Initial payment on signing of the agreement	Rs. 20 million
6 half yearly installments commencing 30 September 2010	Rs. 25 million
Implicit rate of interest per annum	15.192%

Cost of the system is Rs. 100 million whereas maintenance cost of the system for the three years was estimated at Rs. 8.4 million. To cash customers, the system is sold at a mark-up of 25% on cost. HPL expects a gross margin of 30% on such maintenance contracts, whereas actual costs incurred on the maintenance, during the year ended 30 September 2011 amounted to Rs. 2.5 million (2010: Rs. 1.7 million).

The hospital was unable to pay the installment due on 31 March 2011 due to solvency problems. After intense negotiations, HPL and the hospital agreed to a restructuring arrangement, whereby the hospital would settle its obligation by paying 4 half yearly installments of Rs. 32 million each, commencing from 30 September 2011.

Required:

Compute the impact of the above transactions on various items forming part of the statements of comprehensive income and financial position of Hi-Tech Pakistan Limited for the year ended 30 September 2011 in accordance with International Financial Reporting Standards. Give comparative figures. (Notes to the financial statements are not required.) (16 marks)