CHAPTER 15
LEASES

Quick test

Question 1

(a) Off balance sheet financing refers to situations where some or all of a business's debt obligations are excluded from the statement of financial position. Debt balances are included in key financial ratios such as return on capital employed and gearing. If debt can be excluded from the statement of financial position these ratios will appear improved, so companies may wish to reduce their levels of debt in order to look more attractive to potential investors. However if a company has obligations which are not recognised, then its financial statements cannot be said to be faithfully representative, and are misleading.

IAS 17 *Leases* partially addresses one cause of off balance sheet financing – leases. A lease is where one company (the lessee) acquires the right to use an asset for a period of time in return for a payment or series of payments to another company (the lessor), which retains legal ownership of the asset. Prior to any standards dealing with this, the accounting treatment followed the legal form, and the asset remained on the books of the lessor. The lessee's financial statements showed neither the asset nor the obligation for the payments, and the payments were accounted for as rental expenses.

IAS 17 has built on previous US and UK financial reporting standards whose requirements were considered the most acceptable financial reporting solution to the problem of off balance sheet leases as they grew in popularity in the 1970s and 1980s. IAS 17 requires that certain leases, entitled finance leases, follow the substance over form principle and are brought onto the statement of financial position – the asset and the related debt obligation are both recognised. However other leases, entitled operating leases, are still accounted for as rental agreements, with neither the asset nor the lease obligation recognised, and the payments included in the statement of profit or loss on the accruals basis. The obligations of these leases are included only as a disclosure note. Users of the financial statements of companies which have operating leases still have to make approximations to reported figures in the statement of financial position to fully understand the exposure of the companies to all obligations.

The distinction between a finance lease and operating follows the principles of whether the lessee assumes the "risks and rewards" of ownership of the asset under the lease agreement. This requires the application of judgement, although guidelines are provided in IAS 17 to assist.

(b) Few details are provided of the details of this lease to determine whether it is a finance or an operating lease (IAS 17).

Present value of the rental payments
= 150,000 + 150,000/1.1 + 150,000/1.1^2 +150,000/1.1^3
= £523,028
which is equivalent to the cost (or fair value) of the leased asset, and is therefore "substantially all" of the fair value.

Taken with the fact that the lessee can continue to rent the computer for an indefinite period after the end of the four-year lease term for a "peppercorn rent", this indicates that the lease is a finance lease.

Year end	*Obligation at start of year*	*Instalment*	*Obligation after instalment*	*Interest @ 10%*	*Obligation at end of year*
	£	£	£	£	£
20X7	523,028	(150,000)	373,028	37,303	410,331
20X8	410,331	(150,000)	260,331	26,033	286,364
20X5	286,364	(150,000)	136,364		

Statements of financial position at 31 March		**20X7**	**20X8**
		£	£
Non-current assets – assets held under finance leases			
Cost		523,028	523,028
Accumulated depreciation	523,028 / 5*	<u>104,606</u>	<u>209,212</u>
Net book value		<u>418,412</u>	<u>313,816</u>
Current liabilities – obligations under finance leases		150,000	150,000
Non-current liabilities - obligations under finance leases		260,331	136,364
Statements of profit or loss			
Depreciation*		104,606	104,606
Interest		37,303	26,033

* The expected useful life is 5 years, so the asset is depreciated over this period in accordance with IAS 16, and not the lease term.

Question 2

(a) Based on the case, the risks and reward of ownership of the machine have been transferred to Power Tools plc because:

- The lease term of three years is for the majority part of the economic life of the asset
- At the inception of the lease, the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset:
  $PV = 700{,}000 + 700{,}000/1.1 + 700{,}000/1.1^2 + 700{,}000/1.1^3 + 700{,}000/1.1^4 + 700{,}000/1.1^5 = £3{,}353{,}550$
  which is greater than the fair value of the machine (i.e. is substantially all)
- Power Tools is required to insure for the machine and hence has taken on a risk related to the asset

Hence it is accounted for as a finance lease (IAS 17).

(b)

	£000
Statement of profit or loss for the year ended 31 December 20X0	
Depreciation (3,000 / 3 years)	1,000
Interest (300 + 260)	560
Statement of financial position at 31 December 20X0	
Non-current liabilities	1,144
Current liabilities (2,160 - 1,144)	1,016

Working

Period	*Opening obligation*	*Interest*	*Instalment*	*Closing obligation*
	£000	£000	£000	£000
1 to 30/6/X0	3,000	300	(700)	2,600
2 to 31/12/X0	2,600	260	(700)	2,160
3 to 30/6/X1	2,160	216	(700)	1,676
4 to 31/12/X1	1,676	168	(700)	1,144

Question 3

There is evidence that lease described is a finance lease as defined by IAS 17:

- after the lease term expires, Conex has the right to continue with the lease at a "peppercorn rent" of £1
- Conex bears all maintenance and insurance costs (the "risks and rewards of ownership" have passed to the lessee)
- PV of minimum lease payments = £55,405, which is equal to the fair value of the asset

Working

Year	*Quarter*	*Opening obligation*	*Instalment*	*Capital after instalment*	*Finance charge*	*Closing obligation*
		£	£	£	£	£
20X7	1	55,404	5,404	50,000	1,500	51,500
	2	51,500	5,404	46,096	1,383	47,479
	3	47,479	5,404	42,075	1,262	43,337
	4	43,337	5,404	37,933	1,138	39,071
					5,283	
20X8	1	39,071	5,404	33,667	1,010	34,677
	2	34,677	5,404	29,273	878	30,151
	3	30,151	5,404	24,747	742	25,490
	4	25,490	5,404	20,086	603	20,688
					3,233	
20X9	1	20,688	5,404	15,284	459	15,743
	2	15,743	5,404	10,339	310	10,649
	3	10,649	5,404	5,245	157	5,402
	4	5,402	5,402	-	-	-
					926	

Four- year depreciation period as this is the expected useful life of the asset:
Annual depreciation = £55,404 / 4 = £13,851

Statements of financial position

Non-current assets	Cost	Accumulated depreciation	NBV
	£	£	£
Plant and machinery under finance leases			
20X7	55,404	13,851	41,553
20X8	55,404	27,702	27,702
20X9	55,404	41,553	13,851
20Y0	55,404	55,404	-

The total finance lease payable will be split into amounts due within one year (current) and amounts due after one year (non-current).

Non-current liabilities		£
Amounts due under finance leases		
20X7		20,086
Current liabilities		
Amounts due under finance leases		
20X7	(39,071 – 20,086)	18,985
20X8		20,688

Statements of profit or loss	£
Interest payable (includes finance charge)	
20X7	5,283
20X8	3,233
20X9	926
Depreciation	
20X7	13,851
20X8	13,851
20X9	13,851
20Y0	13,851

Question 4

(a) The distinction between a finance and an operating lease (IAS 17) is determined by considering the commercial substance of the lease agreement.

Finance lease
This is a lease agreement which transfers substantially all the risks and rewards incidental to ownership to the lessee. The rewards of owning an asset include obtaining profitable returns or gains from an appreciation in value. Risks of owning an asset include obtaining variable returns from the use of the asset as economic conditions alter or possible losses resulting from the asset lying idle or because it has become technologically obsolete. IAS 17 provides some typical indicators of what may lead a lease to be classified as finance:

- the lease transfers ownership of the asset to the lessee by the end of the lease term
- the lessee has the option to purchase the asset at a price lower than the fair value at the date the option becomes exercisable and it is likely that the lessee will exercise this option
- the lease term is for the major part of the economic life of the asset
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all (often in practice taken as meaning > 90%) of the fair value of the leased asset

- the leased assets are of such a specialised nature that only the lessee can use them without major modifications

Operating lease
An operating lease is any other lease. Indicators of an operating lease are that the risks and rewards incidental to ownership remain with the lessor, and the lessee pays rental for the hire of the asset for a period which is usually less than useful life of asset.

The distinction between the two types of lease is important because the accounting treatment of each is different. That for finance leases addresses one off balance sheet financing issue.

Finance lease
- The asset is capitalised and depreciated over its useful life
- A liability for the lease obligation is recognised
- Payments by the lessee to the lessor are for the full cost of asset plus a return on the provision of finance and so are split between repayment of liability and finance charge shown in statement of profit or loss

Operating lease
- The asset is not capitalised
- The payments are written off to the statement of profit or loss as incurred

(b) The details given indictate that this is a finance lease (IAS 17):
- Nottingham is responsible for maintenance (a risk of ownership)
- PV of the minimum lease payments > substantially all of the fair value of asset: $PV = 45{,}000 + 45{,}000/1.05 + 45{,}000/1.05^2 + 45{,}000/1.05^3 + 45{,}000/1.05^4 + 45{,}000/1.05^5 = £239{,}827$

Accounting treatment:
The asset is capitalised at 'fair value' i.e. the lower of the fair value (the cost of £240,000) and the PV of the minimum lease payments = £239,827. It is depreciated in accordance with IAS 16, over its useful economic life of 5 years.
Annual depreciation = £47,965

Liability is set up at inception of lease for £239,827.

Period	*Obligation at start of period*	*Instalment*	*Obligation after instalment*	*Interest @ 5%*	*Obligation at end of period*
	£	£	£	£	£
End 30/9/X3	239,827	(45,000)	194,827	9,741	204,568
End 31/3/X4	204,568	(45,000)	159,568	7,978	167,546
End 30/9/X4	167,546	(45,000)	122,546	6,127	128,673
End 31/3/X5	128,673	(45,000)	83,673		

Statement of financial position at 31 March 20X4

		£
Non-current assets – assets held under finance leases		
Cost		239,827
Accumulated depreciation		47,965
Net book value		191,862
Non-current liabilities - obligations under finance leases		83,673
Current liabilities – obligations under finance leases		
	(167,546 – 83,673)	83,873

Statement of profit or loss for the year ended 31 March 20X4

Depreciation		47,965
Interest	(9,741 + 7,978)	17,719

Develop your understanding

Question 5

Off balance sheet financing refers to situations where some or all of a business's debt obligations are not recognised on its statement of financial position. If a company has obligations which are not recognised, then its financial statements cannot be said to be faithfully representative. The statement of financial position is used by users to evaluate the financial health of a business. If debt is excluded key financial ratios, such as return on capital employed and gearing, will be improved, and therefore the company may look more attractive to potential investors than one with higher debt. The company may also be able to acquire further debt financing as debt covenants will be more easily met.

A variety of financial transactions can give rise to off balance sheet financing. Leases is a key area, whereby a business obtains the use of a non-current asset for a number of years without acquiring legal title in return for a series of payments over the period. Prior to accounting standards dealing with this issue, companies accounted for leases according to the legal form, and recognised neither the asset nor the obligation for the payments on their statements of financial position. The lease payments were treated as a period expense. In the 1970s and 1980s the use of lease agreements grew enormously, such that it was estimated in the US that billions of dollars of leased items and related obligations were not recognised in the financial statements. IAS 17 *Leases* was the international accounting standard which partially addressed this area, by requiring that certain leases, finance leases, were brought "on balance sheet". However other leases, operating leases were still "off balance sheet".

This international standard follows a "substance over form" approach for finance leases which is consistent with the principles-based approach to financial reporting advocated by the IASB. IAS 17 defines a finance lease as one where substantially all the risks and rewards of ownership are transferred to the lessee, although legal title has not passed. The accounting treatment is based on the commercial or economic substance of the finance lease rather than the legal form. The commercial reality is that the company has acquired the use of a non-current asset and some or all of the risks and benefits, as if the asset were owned, hence the asset is recognised. The corresponding obligations under the agreement are also recognised as a liability. This accounting is consistent with the definitions of assets and liabilities in the IASB's *Conceptual Framework*.

This principles based approach requires the exercise of judgement in the determination of whether a lease is a finance one or an operating one. Some guidance is provided by the standard, but there is evidence that companies structure lease agreements so that they do not quite meet the suggested criteria and therefore remain "off balance sheet". IAS 17 requires that all other operating leases are accounted for as rental agreements, off balance sheet, and with payments accounted for through the statement of profit or loss.

This situation is controversial, with users wanting to see all obligations recognised in the statement of financial position. The IASB has now issued IFRS 16 *Leases* which requires that the vast majority of leases are on balance sheet.

There are many other financial issues that give rise to off balance sheet financing. One key one which has been tackled recently by the IASB, is the question of which investments should be consolidated in an investing company's financial statements. This issue was highlighted particularly by the collapse of the US giant, Enron, where it was discovered that many of its investments, in the form of special purpose entities in which much of Enron's debt had been recognised, were not consolidated, and thus the debt was off the consolidated balance sheet of Enron. The IASB's IFRS 10 *Consolidated Financial Statements* addresses this issue and takes control by the investor over the investee as the criterion to determine whether the investment is consolidated. Again this requires the exercise of judgement.

Other issues giving rise to off balance sheet financing mainly involve the legal sale of assets, but with obligations being incurred to re-acquire the assets in the future. Examples are sale and leaseback arrangements, inventories sold under consignment, debt factoring, and the securitisation of assets. IAS 17 also includes details of how to account for a sale and leaseback arrangement. The IASB has addressed the issue of the potential for an asset and obligation to be off balance sheet from the other types of transactions by considering what constitutes a sale and when revenue from a sale should be recognised in IFRS 15 *Revenue from Contracts with Customers*. This takes a principles-based approach, with the recognition of revenue from a sale being based on transfer of control. This is obviously more consistent with the latest approach to consolidations.

Other complex transactions in financial instruments are continually evolving, and some of these have meant that companies have been able to avoid recognising all their debts on their statements of financial position. The recently completed project on financial instruments has resulted in IFRS 9 *Financial Instruments* which has addressed these sorts of transactions.

Question 6

(a) The substance over form principle ties in with a principles-based approach to accounting. The accounting treatment is based on the commercial or economic substance (reality) of a transaction rather than the legal form.

Instead of purchasing an asset outright, companies will enter into arrangements to lease the asset for a period of time by making regular payments over the period of the lease. Legal ownership remains with the lessor, but the company gains economic benefits from the use of the asset. The commercial substance of many of these transactions is that the company has over the period of the agreement acquired the use of a non-current asset and some or all of the risks and benefits as if the company owned the asset. The asset is used in a similar manner to other non-current assets, even though, legally, it belongs to the lessor.

The substance over form principle implies that an asset acquired under such a lease arrangement should be capitalised and accounted for as all other assets that have been purchased. This accounting treatment also follows from the IASB's definition of an asset – a resource controlled by the entity as a result of past transactions and from which future economic benefits are expected to flow to the entity. The statement of financial position will include the resources which are controlled by the lessee.

IAS 17 takes this approach and therefore requires that assets under lease agreements which transfer substantially all the risks and rewards incidental to ownership to the lessee, i.e. finance leases, are brought onto the statement of financial position. Finance leases are ones where the asset is usually transferred to the lessee for the major part of the asset's life. They are often identified as such if the present value of minimum lease payments is substantially all of the fair value of the asset.

This accounting treatment also implies that a corresponding liability for the obligations under the lease agreement is recognised. This is in accordance with the IASB's definition of a liability – a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources.

Not all lease agreements are treated as finance leases. An operating lease is any other lease. This is treated as a hire agreement since the lessor is considered to retain the risks and rewards of ownership, and the asset is usually leased out to more than one lessee for different periods. Thus neither the asset, nor the corresponding liability is recognised on the statement of financial position.

(b) (i) **Machine X – finance lease (IAS 17)**
- Ferrars bears the risks of ownership (maintenance and insurance costs)
- Lease non-cancellable, so Ferrars bears the risks of gains/losses from the fluctuations in the residual value
- The lease term of 6 years is the same as the economic life
- PV of minimum lease payments (= £60,000 x 8.3840 = £503,040) is

substantially the fair value of the machine (£503,030)
Machine is capitalised at the lower of fair value and PV of minimum lease payments and depreciated over its useful life.
Liability shown for finance provided. Lease payments reduce liability and provide finance charge.

Machine Y – operating lease (IAS 17)

- Lease term is only half of the useful life of the machine
- At the end of the lease term, the machine will revert back to the lessor
- PV of minimum lease payments (= £84,000 x 2.6901 = £225,968) is only three quarters of the fair value of the machine (£300,000)

Lease payments treated as expense in statement of profit or loss.

(ii) **Machine X**

		£
Statement of financial position at 31 December 20X7		
Non-current assets		
Cost		503,030
Accumulated depreciation	(503,030/6)	83,838
NBV		419,192
Non-current liabilities		
Obligations under finance leases		372,587
Current liabilities		
Obligations under finance leases	(441,605 – 372,587)	69,018

Period	*Opening obligation*	*Interest*	*Instalment*	*Closing obligation*
	£	£	£	£
1 to 30/6/X7	503,030	30,182	(60,000)	473,212
2 to 31/12/X7	473,212	28,393	(60,000)	441,605
3 to 30/6/X8	441,605	26,496	(60,000)	408,101
4 to 31/12/X8	408,101	24,486	(60,000)	372,587

Statement of profit or loss for the year ended 31 December 20X7

Expenses		£
Depreciation		83,838
Finance charge	(30,182 + 28,393)	58,575

Machine Y

Statement of profit or loss for the year ended 31 December 20X7

Expenses	£

Operating lease rentals	84,000

Question 7

Note – the accounting treatments also refer to IAS 18 *Revenue*

(i) This is a sale and finance lease back. Although Alpha has given up legal title to the asset it immediately reacquires the risks and rewards of ownership. In such circumstances, there has not in substance been a sale. This transaction represents a secured loan and should be accounted for accordingly. No profit can be reported and the "sales proceeds" are accounted for as a liability. The finance lease rentals are accounted for partly as a capital repayment of the loan and partly as a finance charge in the statement of profit or loss.

(ii) There has been an actual sale as a result of the transfer of risks and rewards of ownership. Because the sale is at fair value, the profit on the transaction is recognised immediately. The asset is derecognised and the operating lease rentals expensed in the statement of profit or loss.

(iii) There has been an actual sale as a result of the transfer of risks and rewards of ownership. The asset is derecognised and the operating lease rentals expensed in the statement of profit or loss. The treatment of the loss on sale depends on the circumstances. If the lease payments are under value, then the loss is deferred and amortised over the period until the end of the lease. Otherwise, the loss is recognised immediately.

(iv) There has been an actual sale as a result of the transfer of risks and rewards of ownership. The asset is derecognised and the operating lease rentals expensed in the statement of profit or loss. The profit on the disposal of the asset must be restricted to the difference between the fair value of the asset and its carrying amount (i.e. £2,000). IAS17 requires that the excess profit (£5,000) is deferred and amortised over the period of the lease. This treatment assumes that the buyer/lessor will charge lease rentals above the market rate to compensate for the loss.

Question 8

Note – parts (c) and (d) as printed belong to part (b)

(a) Although the amount of space the coffee customer uses is specified in the contract, there is no identified asset. The company controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of the airport. The airport has the substantive right to substitute the space the coffee company uses because:

- It has the practical ability to change the space used by coffee company throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and the airport has the right to change the location at any time without the coffee company's approval.

- It would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by the coffee company because the kiosk can be moved easily. The airport benefits from substituting the space in the airport because substitution allows it to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

Consequently the contract does not contain a lease.

(b) There is an identified asset. The aircraft is explicitly specified in the contract and, although the aircraft owner can substitute the aircraft, its substitution right is not substantive because the significant costs involved in outfitting another aircraft to meet the specifications required by the contract are such that the aircraft owner is not expected to benefit economically from substituting the aircraft.

Mediterranean Air Group has the right to control the use of the aircraft throughout the two-year period of use because:

- It has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Mediterranean Air Group has exclusive use of the aircraft throughout the period of use.
- It has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Mediterranean Air Group's right to use the aircraft. Within the scope of its right of use, this company makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels, as well as the passengers and cargo it will transport. Mediterranean Air Group has the right to change these decisions throughout the two-year period of use.

Although the operation of the aircraft is essential to its efficient use, the aircraft owner's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, the aircraft owner does not control the use of the aircraft during the period of use and its decisions do not affect Mediterranean Air Group's control of the use of the aircraft.

The contract therefore contains a lease. Mediterranean Air Group has the right to use the aircraft for two years.

(c) There is no need to assess whether the servers installed at Plantagenet's premises are identified assets. This assessment would not change the analysis of whether the contract contains a lease because Plantagenet does not have the right to control the use of the servers.

Plantagenet does not control the use of the servers because its only decision-making rights relate to deciding upon the level of network services (the output of the servers) before the period of use – the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Plantagenet produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used.

Telcom is the only party that can make relevant decisions about the use of the servers during the period of use. Telcom has the right to decide how data is transported using the servers, whether to reconfigure the servers and whether to use the servers for another purpose. Accordingly, Telcom controls the use of the servers in providing network services to Plantagenet.

The contract does not therefore contain a lease. Instead, the contract is a service contract in which Telcom supplies the equipment to meet the level of network services determined by Plantagenet.

<u>Take it further</u>

<u>Question 9</u>

(a) Under IAS 17 both the lessor and the lessee must determine whether the lease agreement effectively transfers substantially all the risks and rewards from the lessor to the lessee.

In this case, based on the following evidence, both the lessor and the lessee should conclude that such a transfer is achieved and the lease should be classified as a finance lease.

- The lease is non-cancellable
- The lease term is a major part of the economic life of the leased assets (4 out of 5 years)
- The present value of the minimum lease payments is substantially all of the fair value of the leased assets:

Minimum lease payment = (125,000 x 3.5771) + (50,000 x 0.735)
= 447,137.50 + 36,750 = £483,887.50

483,887.50 / 497,000 = 97%

(b) Lease payment schedule

Year	Opening obligation	Payment	Obligation after payment	Interest	Closing obligation
	£	£	£	£	£
20X8	483,887.50	(125,000)	358,887.50	28,711.00	387,598.50
20X9	387,598.50	(125,000)	262,598.50		

Journal entries for the year ended 31 December 20X8

At 1 January 20X8:

			£	£
Dr	Cash		497,000	
Cr	Deferred gain on sales			97,000
Cr	Machine			400,000
Sale of machine under sale and leaseback agreement				
Dr	Leased equipment		483,888	
Cr	Lease liability			483,888
Recognition of lease agreement				
Dr	Lease liability		125,000	
Cr	Cash			125,000
First lease payment				

At 31 December 20X8:

Dr	Depreciation	(483,888 / 5)	96,776	
Cr	Leased equipment			96,776
Depreciation of the machine				
Dr	Deferred gain	(97,000 / 5)	19,400	
Cr	Other income			19,400
Recognition of the gain				
Dr	Interest expense		28,711	
Cr	Lease liability			28,711
Interest on the lease				

Statement of financial position at 31 December 20X8

		£
Non-current assets		
Cost		483,888
Accumulated depreciation		96,776
NBV		387,112
Non-current liabilities		
Obligations under finance leases		262,599
Deferred gain	(77,600 – 19,400)	58,200
Current liabilities		
Obligations under finance leases	(387,599 – 262,599)	125,000
Deferred gain		19,400

Statement of profit or loss for the year ended 31 December 20X8

	£
Expenses	
Depreciation	96,776
Finance charge	28,711
Other income	
Deferred gain on sale of asset under sale and leaseback	19,400

Question 10

(a)

	£
Statement of financial position	
Non-current asset	
Net investment in finance lease (W2)	41,474
Current asset	
Net investment in finance lease (W2) (61,474 – 41,474)	20,000
Statement of profit or loss	
Finance income (W2)	5,589

Workings

(1) Net investment in finance lease (IAS 17)

	Gross investment	*Discount factor (10%)*	*Net investment*
	£		£
1 Jan X4	20,000	1	20,000
1 Jan X5	20,000	$1/1.1$	18,182
1 Jan X6	20,000	$1/1.1^2$	16,529
1 Jan X7	20,000	$1/1.1^3$	15,026
31 Dec X7	7,500	$1/1.1^4$	5,123
Minimum lease payments	87,500		74,860
Unguaranteed residual	1,500	$1/1.1^4$	1,025
	89,000		75,885

Note:
Allowance for the initial direct costs will have been made in computing the 10% interest rate implicit in the lease, so they should be ignored in preparing these extracts.

(2) Statement of financial position and statement of profit or loss figures

		£
Year ended 31 Dec 20X4		
1 Jan X4	Net investment (W1)	75,885
1 Jan X4	Instalment	(20,000)
		55,885

31 Dec X4	Interest income (55,885 x 10%)	5,589
Balance at 31 Dec 20X4		61,474
Year ended 31 Dec 20X5		
1 Jan 20X5	Instalment	(20,000)
		41,474

(b)

	£
Statement of profit or loss	
Leasing income	20,000
Statement of financial position	
Non-current asset	
Property, plant and equipment (W3)	45,962

The lease income of £20,000 per year should be recognised on a straight line basis, as no other system of recognition seems more appropriate in this case. The expected residual value of £9,000 is above the guaranteed residual value of £7,500; this should not be anticipated but recognised at the end of the lease term.

Workings

(3) The asset is measured at its fair value plus direct costs. Direct costs are written off on a straight line basis over the four year lease term (to match revenue from the lease), not the life of the asset.

	At 1 January	*Depreciation on asset @ 40% reducing balance*	*At 31 December*	*Contract acquisition costs, written off over four years*	*Total carrying amount*
	£	£	£	£	£
20X4	75,979	(30,392)	45,587	375	45,962
20X5	45,587	(18,235)	27,352	250	27,602
20X6	27,352	(10,941)	16,411	125	16,536
20X7	16,411	(6,564)	9,847	0	9,847

Question 11

Option 1

Profit on sale = 2.73 million – 2.4 million = £330,000, which is recognised immediately in profit or loss.

As the sales price is below the £2.85 million fair value and the £215,000 annual rental is below the £250,000 market rental, IAS 17 does not require any adjustment to the profit as calculated above.

So the profit is recognised immediately and the subsequent rentals are recognised in profit or loss each year at £210,000. Over the next three years the effect on profit or loss is as follows:

	Year 1	*Year 2*	*Year 3*	*Total*
	£000	£000	£000	£000
Profit on derecognition of depot	330	0	0	330
Rental expense recognised	(210)	(210)	(210)	(630)
Total income / (expense)	120	(210)	(210)	(300)

Option 2
This option generates a profit on sale of £600,000 (3 million – 2.4 million).
This sales price is £150,000 above the £2.85 million fair value, but this seemingly generous extra consideration appears to be clawed back by Goodrich planning to charge above market rentals for the following three years.

IAS 17 requires any excess profit to be initially recognised as deferred income and released to profit or loss over the three years of the leaseback. The profit recognised immediately should be the difference between the £2.85 million fair value and the £2.4 million carrying amount. Over the next three years the effect on profit or loss is as follows:

	Year 1	*Year 2*	*Year 3*	*Total*
	£000	£000	£000	£000
Profit on derecognition of depot	450	0	0	450
Rental expense recognised	(300)	(300)	(300)	(900)
Deferred income released to profit	50	50	50	150
Total income / (expense)	200	(250)	(250)	(300)

<u>Question 12</u>

On 1 January 20X3, Alton makes the lease payment for 20X3 and measures the lease liability at the present value of the remaining 9 payments of £50,000, discounted at the interest rate of 5% per annum = £355,391.

Alton initially recognises assets and liabilities in relation to the lease as follows:

Dr	Right-of-use asset	£405,391	
Cr	Lease liability		£355,391
Cr	Cash (lease payment for the first year)		£50,000

Alton expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

During the first two years of the lease, 20X3 and 20X4, Alton recognises in aggregate the following related to the lease:

Dr	Interest expense (17,770 + 16,158 see table below)	£33,928	
Cr	Lease liability		£33,928

Year	*Liability at start of period*	*Instalment*	*Liability after instalment*	*Interest @ 5%*	*Liability at end of period*
	£	£	£	£	£
20X3	405,391	(50,000)	355,391	17,770	373,161
20X4	373,161	(50,000)	323,161	16,158	339,319
20X5	339,319				

Dr	Depreciation charge (405,391/10 x 2 years)	£81,078	
Cr	Right-of-use asset		£81,078

On 1 January 20X5, the lease liability is £339,319. At this date the CPI has increased to 135. The payments made under the lease arrangement are *reassessed*, and this results in adjustments to both the lease liability and the right-of-use asset.

The payment made on 1 January 20X5, adjusted for the CPI, is £54,000 (£50,000 x 135/125). The lease liability is remeasured to reflect the revised payments, i.e. the lease liability now reflects 8 annual lease payments of £54,000.

Remeasurement of liability (PV of 8 payments of £54,000 discounted at an unchanged discount rate of 5% per annum) = £366,464
The increase in lease liability = 366,464 – 339,319 = £27,145, is accounted for as follows:

Dr	Right-of-use asset	£27,145	
Cr	Lease liability		£27,145

The 20X5 interest and depreciation are accounted for as follows:

Dr	Interest expense (see table below)	£15,623	
Cr	Lease liability		£15,623

Year	*Liability at start of period*	*Instalment*	*Liability after instalment*	*Interest @ 5%*	*Liability at end of period*
	£	£	£	£	£
20X5	366,464	(54,000)	312,464	15,623	328,087
20X6	328,087	(54,000)	274,087		

Dr	Depreciation charge ((405,391 - 81,078 + 27,145)/8)	£43,932	
Cr	Right-of-use asset		£43,932

Summary:

Statements of financial position at 31 December	**20X3**	**20X4**	**20X5**
	£	**£**	**£**
Right-of-use asset			
Cost	405,391	405,391	432,536
Accumulated depreciation	(40,539)	(81,078)	(125,010)
NBV	364,852	324,313	307,526
Current liabilities			
Lease liabilities	50,000	50,000	54,000
Non-current liabilities			
Lease liabilities	323,161	289,319	274,087

Statements of profit or loss for the years ended 31 December	**20X3**	**20X4**	**20X5**
	£	**£**	**£**
Depreciation expense	40,539	40,539	43,932
Finance charge	17,770	16,158	15,623

<u>Question 13</u>

20X1

On 1 January 20X1, the lease liability and right-of-use asset are measured at the present value of 10 payments of £100,000, the first of which is in one year's time, discounted at the interest rate of 6% per annum = £736,009

Statement of financial position at 31 December	**20X1**
	£
Right-of-use asset	
Cost	736,009
Accumulated depreciation	(73,601)
NBV	662,408
Current liabilities	
Lease liabilities (680,170 – 620,980)	59,190
Non-current liabilities	
Lease liabilities	620,980

Statement of profit or loss for the year ended 31 December	**20X1**
	£
Depreciation expense (736,009/10)	73,601
Finance charge	44,161

Working

Year	*Opening liability*	*Interest @ 6%*	*Instalment*	*Closing liability*
	£	£	£	£
20X1	736,009	44,161	(100,000)	680,170
20X2	680,170	40,810	(100,000)	620,980
20X3	620,980	37,259	(100,000)	558,239
20X4	558,239	33,494	(100,000)	491,733
20X5	491,733	29,504	(100,000)	421,237

20X6

On 1 January 20X6 the lease is modified by a change in the consideration. The payments are *reassessed*, and so the lease liability is remeasured based on:
(a) a five-year remaining lease term,
(b) annual payments of £95,000 and
(c) Grafton's incremental borrowing rate of 7% per annum.

Remeasured lease liability = £389,519
The difference between the carrying amount of the modified liability and the lease liability immediately before the modification = 421,237 – 389,519 = £31,718
This is accounted for as an adjustment to (a reduction in the carrying amount of) the right-of-use asset

Statement of financial position at 31 December	**20X6**
	£
Right-of-use asset	
Cost (736,009 – 31,718)	704,291
Accumulated depreciation (5 x 736,009/10) + 67,257	(435,261)
NBV	269,030
Current liabilities	
Lease liabilities (321,785 – 249,310)	72,475
Non-current liabilities	
Lease liabilities	249,310

Statement of profit or loss for the year ended 31 December	**20X6**
	£
Depreciation expense (368,005 – 31,718)/5	67,257

Finance charge	27,266

Working

Year	*Opening liability*	*Interest @ 7%*	*Instalment*	*Closing liability*
	£	£	£	£
20X6	389,519	27,266	(95,000)	321,785
20X7	321,785	22,525	(95,000)	249,310

<u>Question 14</u>

Years ended 30 June 20X4 – 20X8

On 1 July 20X3, the lease liability and right-of-use asset are measured at the present value of 10 payments of £50,000, the first of which is in one year's time, discounted at the interest rate of 6% per annum = £368,005

Summary:

Statements of financial position at 30 June

	20X4	**20X5**	**20X6**	**20X7**	**20X8**
	£	**£**	**£**	**£**	**£**
Right-of-use asset					
Cost	368,005	368,005	368,005	368,005	368,005
Accumulated depreciation	(36,801)	(73,601)	(110,402)	(147,202)	(184,003)
NBV	331,204	294,404	257,603	220,803	184,002
Current liabilities					
Lease liabilities	29,595	31,371	33,253	35,248	37,363
Non-current liabilities					
Lease liabilities	310,490	279,119	245,866	210,618	173,255

Statements of profit or loss for the years ended 30 June

	20X4	**20X5**	**20X6**	**20X7**	**20X8**
	£	**£**	**£**	**£**	**£**
Depreciation expense	36,801	36,800	36,801	36,800	36,801
Finance charge	22,080	20,405	18,629	16,747	14,752

Workings:

Year	*Opening liability*	*Interest @ 6%*	*Instalment*	*Closing liability*
	£	£	£	£
20X4	368,005	22,080	(50,000)	340,085
20X5	340,085	20,405	(50,000)	310,490
20X6	310,490	18,629	(50,000)	279,119
20X7	279,119	16,747	(50,000)	245,866
20X8	245,866	14,752	(50,000)	210,618
20X9	210,618	12,637	(50,000)	173,255

The right-of-use asset is depreciated on the straight-line basis with a life of 10 years
Annual depreciation = 368,005 / 10 = £36,800.50

Years ended 30 June 20X9 – 20Y3

On 1 July 20X8 there is a *lease modification*, with the lease being reduced as a result of the modification. Effectively part of the asset has been sold, and so a gain or loss on the disposal has to be accounted for at this date. This is determined by proportionately reducing both the carrying values of the asset and the lease liability, with the net difference taken to profit or loss as the gain or loss. The lease liability is then remeasured, and the resulting difference between this and the adjusted lease liability is accounted for as for a reassessment.

On 1 July 20X8 Howarth calculates the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset. (2,500 square metres corresponds to 50% of the original right-of-use asset.)

50% of the pre-modification right-of-use asset = 50% x 184,002 = £92,001
50% of the pre-modification lease liability = 50% x 210,618 = £105,309

The accounting is as follows:

Dr	Profit or loss	92,001	
Cr	Right-of-use asset		92,001
Dr	Lease liability	105,309	
Cr	Profit or loss		105,309

resulting in a gain to profit or loss of 105,309 – 92,001 = £13,308

Howarth then remeasures the lease liability based on:
(a) a five-year remaining lease term,
(b) annual payments of £30,000 and
(c) its incremental borrowing rate of 5% per annum.
This equals £129,884

The difference between the remaining lease liability of £105,309 and the modified lease liability of £129,884 (= £24,575) is an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate:

Dr Right-of-use asset	£24,575	
Cr Lease liability		£24,575

Summary:

Statements of financial position at 30 June

	20X9	**20Y0**	**20Y1**	**20Y2**	**20Y3**
	£	**£**	**£**	**£**	**£**
Right-of-use asset					
Cost	392,580	392,580	392,580	392,580	392,580
Accumulated depreciation	(225,718)	(267,434)	(309,149)	(350,865)	(392,580)
NBV	166,862	125,146	83,431	41,715	-
Current liabilities					
Lease liabilities	24,681	25,915	27,211	28,571	-
Non-current liabilities					
Lease liabilities	81,697	55,782	28,571	-	-

Statements of profit or loss for the years ended 30 June

	20X9	**20Y0**	**20Y1**	**20Y2**	**20Y3**
	£	**£**	**£**	**£**	**£**
Gain on part disposal of right-of-use asset	13,308	-	-	-	-
Depreciation expense	41,715	41,716	41,715	41,716	41,715
Finance charge	6,494	5,319	4,085	2,789	1,429

Workings:

Year	*Opening liability*	*Interest @ 5%*	*Instalment*	*Closing liability*
	£	£	£	£
20X9	129,884	6,494	(30,000)	106,378
20Y0	106,378	5,319	(30,000)	81,697
20Y1	81,697	4,085	(30,000)	55,782
20Y2	55,782	2,789	(30,000)	28,571
20Y3	28,571	1,429	(30,000)	-

At 1 July 20X8 the right-of-use asset's carrying amount is increased to 184,002 +24,575 = £208,577 and depreciated over the remaining useful life of 5 years
Annual depreciation = 208,577/5 = £41,715.40