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## **THE ANANTROY BHATT KNOWLEDGE CENTRE**



1. Introduction & terminology
2. Accounting for lease by lessee
3. Accounting for lease by lessor

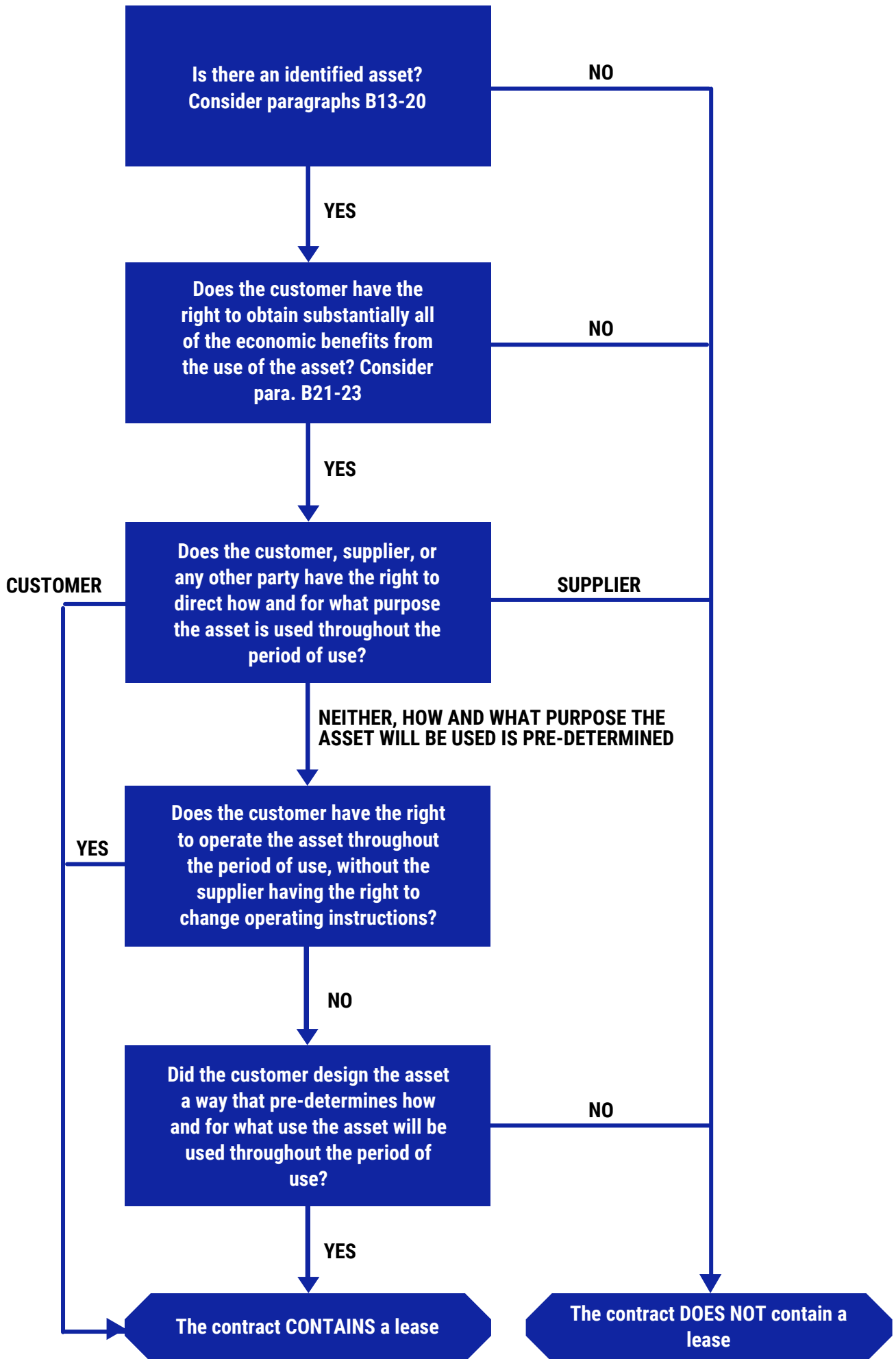
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### **Introduction & Terminology**

IFRS 16 is a new International Financial Reporting Standard for lease accounting which came into force on 1 January 2019. It replaced the existing IAS 17 accounting standard and was introduced by the International Accounting Standards Board (IASB).

Leases are a contract or part of a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

**Consider the following diagram:**



## Lease Accounting For Lessee

A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

- **Short term leases** = Those having a term of 12 months or less, including the effect of extension options. The election for short term leases is by class of asset. A lease that contains a purchase option is not a short-term lease
- **Low value leases** = The leases for which the underlying asset is of low value (eg telephones, laptop computers, and office furniture). The election for low value leases can be made on a lease-by-lease basis. In case, the lessee intends to sub lease the low value assets, the lessee may never account for head lease as low valued asset i.e. the head lease will have to be recognized on SOFP even if it involves an asset that would otherwise said to have low value.

## Lease Types (For Lessor)

- **Finance lease** = A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset is known as finance lease.
- **Operating lease** = A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset is known as operating lease.

## Important Dates

- **Inception date of the lease** = The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease. (The type of lease is identified on this date).
- **Commencement date of the lease** = The date on which a lessor makes an underlying asset available for use by a lessee. (The accounting treatment is applied from this date).

## Important Time Periods

- **Lease term** = The non-cancellable period for which a lessee has the right to use an underlying asset, together with both: (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee.
- **Economic life** = 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. is reasonably certain not to exercise that option.
- **Useful life** = Useful life is the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

## Residual Value

- **Unguaranteed residual value** = Unguaranteed residual value is that portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.
- **Residual value guarantee** = Residual value guarantee is a guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

Part of residual lease guaranteed by:	For Lessee	For Lessor
Lessee	GRV	GRV
Related Party of Lessee	GRV	GRV
Third Party Unrelated To Lessee or Lessor	-	GRV
Related Party Of Lessor	-	UGRV
None	-	UGRV

## Finance Lease Calculation

- **Lease payments** = Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives; (b) variable lease payments that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.
- **Initial direct costs** = are incremental costs for obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.
- **Gross investment in the lease** =  $GI = LP \text{ for lessor} + \text{Unguaranteed residual value (UGRV)}$
- **Net investment in lease (NI)** =  $NI = GI \times \text{Discount Factor using interest rate implicit in the lease}$   
 $NI = PV \text{ of } GI$   
 $NI = GI - UFI$
- **Unearned finance income (UFI)** =  $UFI = GI - NI$
- **Interest rate implicit in the lease** = is the discount rate that, at the inception of the lease, causes:  
 $PV \text{ of } GI = FV \text{ of leased asset} + \text{initial direct cost of lessor}$
- **Lessee's incremental borrowing rate of interest** = The lessee's incremental borrowing rate of interest is the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of use asset in a similar economic environment.

## How To Calculate Present Value (PV) Discount Factor

- Single payment:

$$(1 + i)^{-n}$$

- Annuity end period:

$$\frac{1 - (1 + i)^{-n}}{i}$$

- Annuity due (beginning period):

$$\frac{1 - (1 + i)^{-n+1}}{i} + 1$$

## Lease Classification (For Lessor)

Whether lease is a finance lease or an operating lease depends on the substance of the transaction rather than form of the contract. The main factor is risk and rewards. Where repair and maintenance charges, insurance charges, the loss due to idle capacity are to be borne by lessee and the major economic benefits are to accrue to lessee, there is an indication that risk and rewards have been transferred to lessee.

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are (not conclusive factors – risk and rewards are):

- Transfer of ownership to lessee at the end of lease term;
- The bargain purchase option or bargain renewal option at the end of lease term;
- The lease term is 75% (generally) or more of asset's economic life;
- PV of MLP is 90% (generally) or more of FV of asset;
- The leased asset is of such specialized nature that only lessee can use it without major modification;
- Lessor's losses associated with the cancellation of lease are borne by the lessee;
- Gain or losses from the fluctuation in fair value accrue to the lessee.
- The lessee has the ability to continue the lease for secondary period at a rent that is substantially lower than market rent.

Leases are classified at the inception of the lease. Sometimes, a lessee and lessor agree to change the provisions of a lease and the changes might be of a sort that would have changed the lease classification if the new terms had been in effect at the inception of the lease. In these cases, the revised agreement is regarded as a new agreement over its term.

However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

**Initial Recognition & Measurement**

Dr. Right of use

Cr. Lease liability  
 Cr. Bank (amount already paid)  
 Cr. Bank (initial direct costs)  
 Cr. Provision (IAS 37)

- **Right of use asset =** At the commencement date of the lease, a lessee recognises a right-of-use asset at cost, comprising: (a) The amount of the lease liability recognised; (b) Any lease payments made at or before the commencement date, less any lease incentives; (c) Any initial direct costs incurred; and (d) An estimate of costs to be incurred to dismantle and remove an asset and restore the site based on the terms and conditions of the lease.
- **Examples of initial direct costs of a lessee include** commissions, legal fees\*, costs of negotiating lease terms and conditions\*, costs of arranging collateral and payments made to existing tenants to obtain the lease. \* if they are contingent on origination of the lease
- **Lease liability =** At the commencement date of the lease, a lessee recognises a lease liability for the unpaid portion of payments (and guaranteed residual value, if any), discounted at the rate implicit in the lease or, if this is not readily determinable, the incremental rate of borrowing.

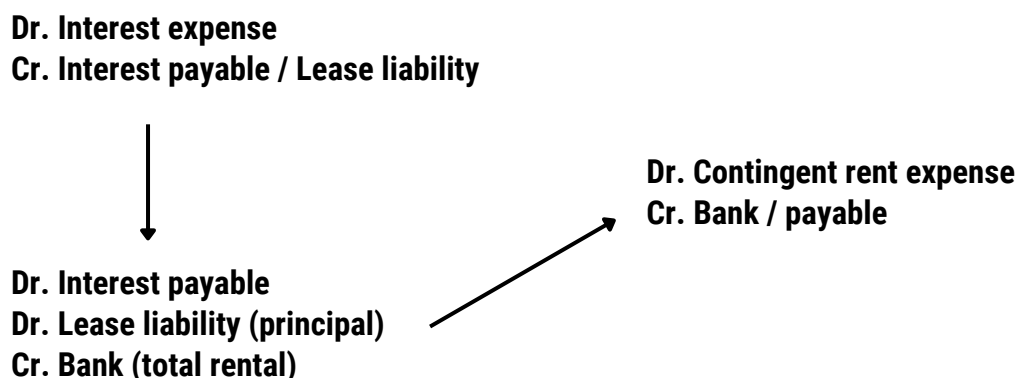
**Subsequent Measurement - Right of Use Asset (Three Options)**

Dr. Depreciation expense

Cr. Right to use asset / Acc. Depreciation

Cost Model (IAS 16)	Revaluation Model (IAS 16)	Investment Property (IAS 40)
<ul style="list-style-type: none"> <li>• Apply IAS 16 to record depreciation.</li> <li>• Depreciation period is the useful life of the asset if the lease transfers ownership of the underlying asset; otherwise earlier of the asset's useful life and lease term.</li> <li>• Adjust carrying value based on any re-measurement.</li> </ul>	<p>If lessee applies the revaluation model to a class of asset, it may elect to apply that model to the same class of right-of-use assets.</p>	<p>If a lessee applies the fair value model to its investment property, the lessee is required to apply that model to right-of-use assets that meet the definition of investment property in IAS 40.</p>

## Subsequent Measurement - Lease Liability



After the commencement date, a lessee re-measures the lease liability by: (a) Increasing the carrying amount to reflect interest on the lease liability; (b) Reducing the carrying amount to reflect the lease payments made; and

Variable lease payments that have not been included in the initial measurement of the lease liability are recognised in the period in which the event or condition that triggers the payments occurs

## Presentation

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<p><b><u>Right-of-use assets:</u></b></p> <ul style="list-style-type: none"> <li>• Present right-of-use assets separately from other assets; or</li> <li>• Include right-of-use assets within the same line item as the underlying asset</li> </ul> <p>The requirement in (a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.</p> <p><b><u>Lease liabilities:</u></b> Present separately from other liabilities or disclose the line item in which they are included.</p>	<ul style="list-style-type: none"> <li>• Principal payments on the lease liability as financing activities.</li> <li>• Payments of interest in accordance with guidance for interest paid in IAS 7 Statement of Cash Flow.</li> <li>• Short-term and low-value asset leases and variable lease payments that are not included in the measurement of lease liabilities are classified within operating activities.</li> </ul>	<p>Interest expense on the lease liability is presented separately from depreciation of the right-of-use asset, as a component of finance costs.</p>

## **Disclosures**

**A lessee shall disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.**

**A lessee shall disclose the following amounts for the reporting period:**

- **depreciation charge for right-of-use assets by class of underlying asset;**
- **interest expense on lease liabilities;**
- **the expense relating to short-term leases. This expense need not include the expense relating to leases with a lease term of one month or less;**
- **the expense relating to leases of low-value assets. This expense shall not include the expense relating to short-term leases of lowvalue assets;**
- **the expense relating to variable lease payments not included in the measurement of lease liabilities;**
- **income from subleasing right-of-use assets;**
- **total cash outflow for leases;**
- **additions to right-of-use assets;**
- **gains or losses arising from sale and leaseback transactions; and**
- **the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.**

**A lessee shall provide the disclosures specified in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.**

**A lessee shall disclose the amount of its lease commitments for shortterm leases accounted if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed.**

**If a lessee measures right-of-use assets at revalued amounts applying IAS 16, the lessee shall disclose the information specified in relevant disclosure of IAS 16 for those right of use assets.**

**Under IFRS 16 the financial liability of lessee under lease arrangement requires a maturity analysis that is dealt by IFRS 7. According to IFRS 7, the lessee is required to disclose maturity analysis of lease liability for remaining contractual maturities. The contractual maturities are the future lease payments (without discounting).**

**Moreover, application guidance (B11) of IFRS 7, Financial Instruments: Disclosures requires that in preparing the maturity analysis, a lessee uses its judgment to determine an appropriate number of time bands.**



**Finance Lease Accounting - Normal Lessor**

Journal Entry	Time of Recognition	By The Amount
Dr. Net investment Cr. Asset Cr. Bank/Payables	Commencement of lease term	PV of (LP + UGRV) Fair value Initial direct costs
Dr. Interest receivable Cr. Interest income	At year end	The interest accrued during the year
Dr. Bank Cr. Interest receivable Cr. Net Investment	At the time payment/rental is received	Total rental, Interest, Principal amount (Schedule)
Dr. Bank / accrual Cr. Variable rent	The period in which they are incurred	As calculated under agreement

**Finance Lease Accounting - Manufacturer or Dealer Lessor**

Journal Entry	Time of Recognition	By The Amount
Dr. Net investment Cr. COS Cr. Sales revenue	Commencement of lease term	PV of (LP + UGRV) PV of UGRV PV of LP at market rate
Dr. COS Cr. Inventory		Cost of goods leased

*Continued on next page...*

Journal Entry	Time of Recognition	By The Amount
Dr. Selling exp. Cr. Cash	When Incurred	Initial direct costs
Dr. Interest receivable Cr. Interest income	At year end	The interest accrued during the year
Dr. Bank Cr. Interest receivable Cr. Net Investment	At the time payment/rental is received	Total rental, Interest, Principal amount (Schedule)
Dr. Bank / accrual Cr. Variable rent	The period in which they are incurred	As calculated under agreement

### Important Points - Lessor

Lessors shall recognize assets held under finance lease in their statement of financial position and present them as a receivable at an amount equal to the NI (GI – UFI).

The interest rate in the lease is defined in such a way that the initial direct costs are included automatically in finance lease receivable; there is no need to add them separately.

Manufacturer and dealer lessors shall recognise 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 such amount as if a market rate of interest were charged.

### Accounting For Operating Lease - Lessor

Lease income from operating lease shall be recognized on a straight-line basis over the lease term unless another systematic basis is more representative of benefit derived from the leased asset.

Asset shall be presented in statement of financial position as per its nature.

Initial direct costs 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 is to be charged as per normal depreciation policy.

Journal Entry:                      Dr. Bank/accrual  
                       Cr. Lease/Rent income

## **Disclosures**

### **Finance lease**

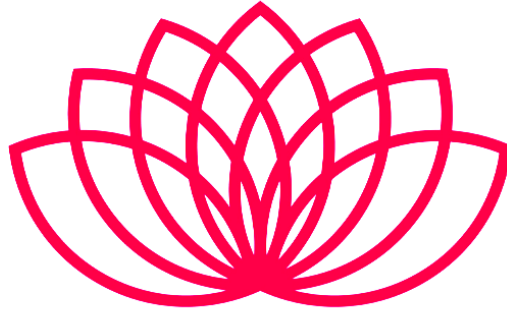
- **Selling profit or loss**
- **Finance income on the net investment in the lease**
- **Income relating to variable lease payments not included in the measurement of the net investment in the lease**
- **Qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in the lease**
- **Maturity analysis of undiscounted lease payment receivable for a minimum of each of the first five years plus a total amount for the remaining years.**
- **A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value**

### **Operating lease**

- **Lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate**
- **Maturity analysis of undiscounted lease payments to be received for a minimum of each of the first five years plus a total amount for the remaining years**
- **Disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases**
- **Disclosure requirements in IAS 16 for items of property, plant and equipment subject to an operating lease**

### **Qualitative disclosures all leases**

- **Nature of the lessor's leasing activities**
- **Management of the risk associated with any rights that the lessor retains in underlying assets.**



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