

# Accounting standard study group

## CIMA Sri Lanka division

### Study of SLAS 19: Leases

**Objective:** Prescribe for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to finance and operating leases.

**Scope:** This standard shall be applied in accounting for all leases other than:

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

- property held by a lessee that is accounted for as investment property
- investment property provided by lessors under operating leases
- biological assets held by lessees under finance leases, and
- biological assets provided by lessors under operating leases.

This standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.

This standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

#### Essential 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.

**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:

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

**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.



## Classification of leases

Lease classification is made at the inception of the lease. If at any time the original conditions of the leases are altered in a manner that would result in a different classification of the lease, the revised agreement is regarded as a new agreement over its term.

### Supplementary conditions relevant to classification of land and building leases

The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification.

#### Classified as a finance lease;

If title to both elements is expected to pass to the lessee by the end of the lease term it is classified as a finance lease

#### Classified as an operating lease;

If the land has an indefinite economic life it is classified as an operating lease.

If the land and buildings are treated as a single unit for the purpose of lease classification and classified as a finance or operating lease the economic life of the buildings is regarded as the economic life of the entire leased asset.

## Other related SLAS

**SLAS 40 (revised 2005)** - If the land and property classified as an investment property.

## Leases in the Financial Statements of Lessees

### Finance leases – initial recognition

At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets 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.

Any initial direct costs of the lessee are added to the amount recognised 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.

A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. For calculation of depreciation charges please refer SLAS 18 Property, Plant and Equipment (Revised 2005) and SLAS 37 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.

In addition, the requirements for disclosure in accordance with SLAS 18, SLAS 41, SLAS 37 and SLAS 40 apply to lessees for assets leased under finance leases.

### Operating leases

Lease payments under an operating lease shall be recognised 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.

For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

## Leases in the Financial Statements of Lessors

### Finance leases - initial recognition

Lessors shall recognise assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease.

Under a finance lease substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.

Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by sales and marketing team.

For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the lease term.

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

### 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.

A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease. Lease payments relating to the period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately.

An asset under a finance lease that is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with SLAS 38 Non-current Assets Held for Sale and Discontinued Operations (Revised 2006) shall be accounted for in accordance with that standard.

### Operating Leases

Lessors shall present assets subject to operating leases in their balance sheets according to the nature of the asset.

Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised on a straight-line basis over the lease term even if the receipts are not on such a basis, 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 recognised 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 SLAS 18 (Revised 2005) and SLAS 37.

To determine whether a leased asset has become impaired, an entity applies SLAS 41.

In addition, the disclosure requirements in SLAS 18 (Revised 2005), SLAS 41, SLAS 37, SLAS 40 (Revised 2005) apply to lessors for assets provided under operating leases.

### **Sale and leaseback transactions**

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

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately. If the sale price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised 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 amortised over the period for which the asset is expected to be used.

If the leaseback is an operating lease, and the lease payments and the sale price are at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately.

For finance leases, no such adjustment is necessary unless there has been impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with SLAS 41.

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

Sale and leaseback transactions may trigger the separate disclosure criteria in SLAS 3 Presentation of Financial Statements (Revised 2005).

### **Disclaimer**

This document is compiled with the objective of presenting a basic overview of the respective Sri Lanka Accounting Standard, and does not construe professional advice in application of the Standard. For specific application and understanding of all facets of the Standard, the relevant Sri Lanka Accounting Standard issued by The Institute of Chartered Accountants of Sri Lanka should be referred.

## Useful web-links pertaining to accounting standards

<http://www.icasrilanka.com/Technical/Accounting%20Standards.html>

<http://www.iasb.org/Home.htm>

## Compiled by the members of the Accounting Standard Study Group

Manil Jayasinghe (Chairman)

Achintha Gamage

Chamil Hathurusinghe

Jayani Amarasinghe

Kanagasabapathy Arulmoly

Methmal Seneviratne

Nilushika Gunasekera

Dharshan Cooray

