

May 2013

Illustrative Examples
Exposure Draft ED/2013/6

Leases

Comments to be received by 13 September 2013

**Illustrative Examples on
Exposure Draft
Leases**

Comments to be received by 13 September 2013

These Illustrative Examples accompany the Exposure Draft ED/2013/6 *Leases* (issued May 2013; see separate booklet). The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **13 September 2013** and should be submitted in writing to the address below or electronically via our website www.ifrs.org using the 'Comment on a proposal' page.

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[Draft] International Financial Reporting Standard X Leases Illustrative examples

These examples accompany the [draft] Standard. They illustrate aspects of the [draft] Standard but are not intended to provide interpretative guidance.

- IE1 The following examples illustrate how an entity might apply some of the requirements in the [draft] Standard to particular aspects of a lease (or other contracts) based on the limited facts presented. Additional facts would most probably be required to fully evaluate the contract, which could change the evaluations following each example.
- IE2 The examples correspond with the following topics in the [draft] Standard:
- (a) identifying a lease (paragraph IE3);
 - (b) allocating consideration to components of a contract (paragraph IE4);
 - (c) lease components and identifying the primary asset (paragraph IE5);
 - (d) short-term lease (paragraph IE6);
 - (e) lease classification (paragraph IE7);
 - (f) lessee measurement and reassessment of the lease term (paragraph IE8);
 - (g) lessee accounting for purchase options (paragraph IE9);
 - (h) lessee accounting for variable lease payments (paragraphs IE10–IE11);
 - (i) lessor measurement for Type A leases (paragraphs IE12–IE14);
 - (j) sale and leaseback transaction (paragraph IE15);
 - (k) lessee transition—operating lease to Type A lease (paragraph IE16);
 - (l) lessee transition—operating lease to Type B lease (paragraph IE17); and
 - (m) lessor transition—operating lease to Type A lease (paragraph IE18).

Identifying a lease

IE3 The following examples illustrate how an entity determines whether a contract is, or contains, a lease.

Example 1—Contract for rail cars

Example 1A: A contract between Customer and a freight carrier (Carrier) provides Customer with the use of 10 rail cars of a particular specification owned by Carrier for five years. The contract specifies the type of car. Customer determines when, where and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. If a particular car needs to be serviced or repaired, Carrier is required to substitute an equivalent car of the same type. Otherwise, and other than on default by Customer, Carrier cannot retrieve the cars during the five-year period.

The contract also requires Carrier to provide an engine and a driver when requested by Customer and stipulates that, if Carrier is unable to do so, Customer has the right to hire an engine and a driver from other suppliers. Carrier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Carrier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (ie if other customers require the transport of goods to destinations close to the destination requested by Customer and within a similar timeframe, Carrier can choose to attach up to 100 rail cars to the engine).

The contract contains a lease of rail cars. Customer has the right to use 10 rail cars for five years.

Fulfilment of the contract depends on the use of 10 identified cars. Once delivered to Customer, Carrier can substitute the cars only when they are not operating properly.

Customer has the right to control the use of the cars because of both of the following:

- (a) Customer has the ability to direct the use of the cars. Customer determines how, when and for what purpose the cars are used, not only when they are being used to transport Customer's goods but throughout the term of the contract.
- (b) Customer has the ability to derive the benefits from use of the cars. The cars are available for Customer's use throughout the term of the contract, including when they are not being used to transport Customer's goods.

The contract also contains a non-lease (service) component that relates to the use of an engine and a driver. The contract does not convey the right to use an identified engine (see analysis in Example 1B).

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Example 1—Contract for rail cars

Example 1B: The contract between Customer and Carrier requires Carrier to transport a specified quantity of goods in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified is equivalent to Customer having the use of 10 rail cars for five years. Carrier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported but does not include specific details about the cars or engine to be used to transport Customer's goods. Although transporting the goods identified in the contract requires cars similar to those identified in Example 1A, Carrier has a large pool of similar cars that can be used to transport Customer's goods. Similarly, Carrier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored in Carrier's premises when not being used to transport goods.

The contract does not contain a lease.

Fulfilment of the contract does not depend on the use of 10 identified rail cars or an identified engine because Carrier has substantive substitution rights. Carrier can choose the cars and engine without Customer's consent. There are also no economic barriers that prevent Carrier from using any car within the pool of cars of a particular specification, and any one of a number of engines, for each delivery of Customer's goods.

Example 1C: Assume the same facts as in Example 1B except that Carrier has only 10 rail cars of the specification required to transport Customer's goods. Carrier can also use those cars to fulfil other contracts if those cars are not being used to transport Customer's goods, and Carrier could decide to expand its fleet of cars during the term of the contract. Cars of the specification required to transport Customer's goods can be purchased from rail car suppliers and are readily available to Carrier.

The contract does not contain a lease.

Although the 10 rail cars owned by Carrier are identified at the commencement of the contract, Customer does not have the right to control their use throughout the term of the contract. Carrier controls the use of the rail cars. Carrier makes the substantive decisions about how the rail cars are used to deliver goods including, for example, whether to use the rail cars to fulfil other contracts. Carrier could fulfil the contract with Customer using rail cars other than those owned at the commencement of the contract if, for example, Carrier were to decide to expand its fleet of rail cars during the term of the contract.

Specifying the quantity of goods to be transported and the timetable for delivery, means, in effect, that Customer specifies the output from the use of rail cars but it does not give Customer the right to use the 10 rail cars for five years.

Example 2—Contract for coffee services

Customer enters into a contract for coffee services for two years. Supplier puts 25 coffee machines in Customer's premises that are tailored for use with coffee consumables provided by Supplier. The coffee machines function only with the consumables provided by Supplier and have no use to Customer other than when they are used in conjunction with those consumables. Supplier is responsible for repairs and maintenance of the coffee machines. Customer's staff operate the machines (ie they select the coffee they wish to drink and the machines deliver the coffee).

The contract does not contain a lease.

Although fulfilment of the contract may depend on the use of the machines, the contract does not give Customer the right to control the use of those machines. That is because Customer does not have the ability to derive the benefits from use of the machines on their own; the machines function only with the consumables that are supplied by Supplier. Accordingly, the machines have no use or value to Customer without the consumables. The machines are incidental to the delivery of the coffee services. The machines and the consumables combine to deliver coffee services to Customer over the two-year term of the contract.

Example 3—Contract for medical equipment

Customer enters into a contract for medical equipment for three years. Supplier puts 10 items of patient-monitoring equipment in Customer's premises that require the use of disposable consumables that connect the monitoring equipment to the patient. Although the contract requires Customer to purchase the consumables from Supplier, consumables that function with the monitoring equipment are readily available from other suppliers. Supplier carries out repairs and maintenance of the monitoring equipment when needed and can replace the equipment without the consent of Customer (although, because of the costs associated with replacing the equipment, Supplier would replace the equipment only if it is not operating properly). Customer determines how and when the equipment is used, and operates the equipment to monitor patients.

The contract contains a lease of the patient-monitoring equipment.

Although the terms of the contract require Customer to use Supplier's consumables, consumables that function with the patient-monitoring equipment are readily available from other suppliers. Accordingly, Customer would be able to derive the benefits from use of the monitoring equipment on its own without Supplier's consumables. In addition, although the terms of the contract require Customer to use Supplier for repairs and maintenance, this is a non-lease (service) component of the contract that does not change the conclusion that Customer has the right to use the equipment. Consequently, the contract has three separate components: the right to use the equipment, the supply of consumables, and the maintenance of the equipment.

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Example 3—Contract for medical equipment	
The contract conveys the right to use the patient-monitoring equipment to Customer for the following reasons:	
(a)	Fulfilment of the contract depends on the use of the equipment. Supplier's substitution rights are not substantive because the costs of replacing the equipment create an economic barrier that prevents Supplier from replacing the equipment other than when it is not operating properly.
(b)	Customer has the right to control the use of the equipment because of the following:
(i)	Customer has the ability to direct the use of the equipment. Customer determines how and when the equipment is used and it operates the equipment. Accordingly, Customer makes decisions about the use of the equipment that most significantly affect the economic benefits derived from use throughout the term of the contract.
(ii)	Customer has the ability to derive the benefits from use of the equipment. The equipment is available solely for Customer's use throughout the three-year term of the contract.

Example 4—Contract for fibre-optic cable	
<i>Example 4A: Customer enters into a 15-year contract for the right to use three specified, physically distinct dark fibres within a larger cable connecting Hong Kong to Tokyo. Customer makes all of the decisions about the use of the fibres by connecting each end of the fibres to its electronics equipment (ie Customer 'lights' the fibres). If the fibres are damaged, Supplier is responsible for the repairs and maintenance.</i>	
The contract contains a lease. Customer has the right to use the three dark fibres for 15 years.	
Fulfilment of the contract depends on the use of the fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable.	

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Example 4—Contract for fibre-optic cable	
Customer has the right to control the use of the dark fibres because of the following:	
(a)	Customer has the ability to direct the use of the dark fibres. Customer determines how, when and for what purpose the fibres are used. Accordingly, Customer makes decisions about the use of the fibres that most significantly affect the economic benefits derived from use throughout the term of the contract.
(b)	Customer has the ability to derive the benefits from use of the dark fibres. The fibres are available for Customer's use throughout the 15-year term of the contract; they cannot be used by any other party unless Customer agrees to such use.
The contract also contains a non-lease (service) component for repairs and maintenance of the fibres.	
<i>Example 4B: Customer enters into a 15-year contract for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of three fibre strands within the cable (the cable contains 15 fibres with similar capacities). Supplier makes decisions about the transmission of data (ie Supplier lights the fibres and makes decisions about which fibres are used to transmit Customer's traffic).</i>	
The contract does not contain a lease.	
Supplier makes all decisions about the transmission of Customer's data, which requires the use of only a portion of the capacity of the cable. That capacity portion is not physically distinct from the remaining capacity of the cable. Customer has contracted for the right to capacity within a cable. It does not have the right to use an identified asset.	

Example 5—Contract for energy/power	
<i>Example 5A: Customer enters into a contract to purchase substantially all of the energy produced by a new power plant for 20 years. The power plant is owned by Supplier and the energy cannot be provided from another plant. Supplier and Customer were both involved in designing the plant before it was constructed. Customer has the right to either operate and maintain the plant itself, or appoint another party to operate and maintain the plant, in accordance with industry-approved operating practices.</i>	
The contract contains a lease. Customer has the right to use the power plant for 20 years.	
Fulfilment of the contract depends on the use of the power plant. The energy cannot be supplied from another plant.	

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Example 5—Contract for energy/power

Customer has the right to control the use of the power plant because of the following:

- (a) Customer has the ability to direct the use of the power plant. Customer has determined how the plant will be operated by both being involved in designing the plant and appointing the party that operates and maintains the plant. Customer's decision-making rights about the design and maintenance of the plant have given it the ability to make decisions about the use of the plant that most significantly affect the economic benefits derived from use throughout the term of the contract. Although another party might operate the plant on a daily basis, that party would be implementing decisions made by Customer about the use of the plant.
- (b) Customer has the ability to derive the benefits from use of the plant. Customer has the right to obtain substantially all of the energy produced by the plant throughout the 20-year term of the contract.

Example 5B: An electricity provider (Customer) enters into a contract to purchase substantially all of the power produced by a power plant for three years. The power plant is owned and operated by a utility company (Supplier). Supplier cannot provide power from another plant. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer—Customer had no involvement in that design. Customer issues dispatch instructions to Supplier. Those instructions detail the quantity and timing of delivery of power to Customer. Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Customer and Supplier agree to the plant's maintenance plan at the start of the contract. Customer's only decision-making authority relates to the dispatch instructions. Supplier is able to sell the power not taken by Customer to other customers.

The contract does not contain a lease.

Although fulfillment of the contract depends on the use of the power plant, Customer does not have the right to control its use because it does not have the ability to direct the use of the plant. Supplier has that ability. Supplier has made (and will make) all decisions about how the plant operates. Customer's ability to determine when power is produced, in effect, gives it the ability to specify the output from the plant. However, without any other decision-making authority, Customer has no ability to direct the use of the plant that is used to make the power.

Allocating consideration to components of a contract

IE4 The following example illustrates the allocation of consideration in a contract to lease and non-lease components by a lessee.

Example 6—Lessee allocation of consideration to lease and non-lease components of a contract

Customer enters into a five-year contract with Supplier for a total consideration of CU200,000,^(a) payable annually in five amounts of CU40,000. The contract has two components:

Component 1—lease of equipment for five years;

Component 2—maintenance of the equipment by Supplier for five years.

The contract does not specify prices for the individual components.

The manufacturer of the equipment requires that all lessors of the equipment include maintenance services as part of the contract with the lessee. Accordingly, Supplier cannot lease the equipment without also requiring the lessee to purchase maintenance services that relate to the equipment. The contract is priced as a package, and Customer is unable to obtain an observable stand-alone price for the lease component.

Customer is, however, able to obtain an observable stand-alone price for the service component on the basis of information that is available from other suppliers. Several other suppliers provide maintenance services that relate to similar equipment over a five-year period at a stand-alone price of CU10,000 per year.

Because Customer has an observable stand-alone price for one component, but not both, it first allocates consideration to the component with an observable price and then allocates the remaining consideration to the component without an observable price. Customer concludes that the consideration for the lease component is CU30,000 per year (CU40,000 per year – CU10,000 per year allocated to the service component of the contract).

(a) In these Illustrative Examples, currency amounts are denominated in 'currency units' (CU).

Lease components and identifying the primary asset

IE5 The following examples illustrate how an entity would identify separate lease components in a contract and the primary asset within one lease component that conveys the right to use more than one asset to the lessee.

Example 7—Lease of retail space

A lessee enters into a lease of retail space together with the surrounding land that is used for parking and deliveries. Because of the location of the retail space, a retailer would not lease the building without the surrounding land. The lessee is a retailer that intends to use the building for its retail operations.

The contract contains one lease component. The retail space is dependent on the land for parking and deliveries. The lessee would be unable to access the benefits from use of the retail space without the surrounding land for parking and deliveries. Accordingly, the lessee cannot benefit from use of the retail space without also using the surrounding land that is part of the contract.

The primary asset is the retail building because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the surrounding land for parking and deliveries is to facilitate the lessee obtaining benefits from use of the retail space.

Example 8—Lease of retail space plus an additional plot of land

Assume the same facts as Example 7, except that the contract also conveys the right to use an additional plot of land that is located adjacent to the retail space. The additional plot of land could, for example, be redeveloped independently of the retail space.

The contract contains two lease components—a lease of the retail space (together with the surrounding land for parking and deliveries) and a lease of a plot of land.

The plot of land is neither dependent on, nor highly interrelated with, the retail space and vice versa. Accordingly, the lessee can benefit from use of the plot of land on its own and, as described in Example 7, the lessee can benefit from use of the retail space (together with the surrounding land for parking and deliveries) on its own.

Example 9—Lease of a manufacturing plant

A lessee leases a manufacturing plant together with a large item of equipment that is installed within the plant. The lessor does not lease or sell the equipment separately but other suppliers do. The plant is not tailored for use only with that item of equipment, and the equipment could be used for a different manufacturing process within another plant.

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Example 9—Lease of a manufacturing plant

The contract contains two lease components—a lease of the manufacturing building (together with the land on which the building is situated) and a lease of an item of manufacturing equipment.

The item of equipment is neither dependent on, nor highly interrelated with, the plant and vice versa, ie both the plant and the equipment could be used for other purposes together with other assets. Accordingly, the lessee can benefit from use of the plant together with other resources that are readily available to it. The lessee also can benefit from use of the equipment together with other resources that are readily available to it.

Example 10—Lease of a turbine plant

A lessee leases a turbine plant, which consists of a large turbine housed within a building, together with the land on which the turbine is situated. The building was designed specifically to house the turbine and the life of the building is directly linked to the life of the turbine (ie when the turbine can no longer be used and is dismantled, the building will be demolished or substantially rebuilt).

The contract contains one lease component. The building and the land on which the turbine is situated are highly interrelated with the turbine. Accordingly, the lessee cannot benefit from use of the building or the land without also using the turbine. Similarly, the lessee could not benefit from use of the turbine if it were not housed within the building.

The primary asset is the turbine because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the building (and the land on which the turbine is situated) is to facilitate the lessee obtaining benefits from use of the turbine. The land and building would have little, if any, use or value to the lessee without the turbine.

Short-term lease

IE6 The following example illustrates the assessment of whether a lease is a short-term lease.

Example 11—Short-term lease

A lessee has made an accounting policy election not to recognise a right-of-use asset and a lease liability that arise from short-term leases for any class of underlying asset.

The lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months. The lessee does not have a significant economic incentive to exercise the option to extend.

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Example 11—Short-term lease

The lease does not meet the definition of a short-term lease because the maximum possible term under the contract is longer than 12 months (ie the maximum possible term under the contract is two years). Consequently, the lessee recognises a right-of-use asset and a lease liability. Because there is no significant economic incentive to exercise the option to extend, the lessee determines the lease term to be 12 months and measures the right-of-use asset and the lease liability accordingly.

Lease classification

IE7 The following examples illustrate lease classification.

Example 12—Equipment lease classification

A lessee enters into a two-year lease of an item of equipment, which has a total economic life of 12 years. The lease payments are CU9,000 per year, the present value of which is CU16,700 calculated using the rate the lessor charges the lessee. The fair value of the equipment at the commencement date is CU60,000.

The lessee determines that the lease is a Type A lease because of the following:

- (a) the underlying asset is not property;
- (b) the lease term is for more than an insignificant part of the total economic life of the equipment; and
- (c) the present value of the lease payments is more than insignificant relative to the fair value of the equipment at the commencement date.

Example 13—Commercial property lease classification

A lessee enters into a 15-year lease of an office building, which has a remaining economic life of 40 years at the commencement date. The lease payments are CU30,000 per year, the present value of which is CU300,000, calculated using the lessee's incremental borrowing rate (ie the rate the lessor charges the lessee is not readily determinable to the lessee). The fair value of the property at the commencement date is CU400,000.

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Example 13—Commercial property lease classification	
The lessee determines that the lease is a Type B lease because of the following:	
(a)	the underlying asset is property;
(b)	the lease term is not for a major part of the remaining economic life of the property; and
(c)	the present value of the lease payments does not account for substantially all of the fair value of the property.

Lessee measurement and reassessment of the lease term

IE8 The following examples illustrate how a lessee would initially and subsequently measure lease assets and lease liabilities. They also illustrate how a lessee would account for a change in the assessment of the lease term.

Example 14—Initial and subsequent measurement by a lessee and accounting for a change in the lease term	
<i>Part 1—Initial and subsequent measurement of the right-of-use asset and the lease liability</i>	
A lessee enters into a 10-year lease of an asset, with an option to extend for five years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. The lessee incurs initial direct costs of CU15,000.	
At the commencement date, the lessee concludes that it does not have a significant economic incentive to exercise the option to extend and therefore determines the lease term to be 10 years.	
The rate that the lessor charges the lessee is not readily determinable. The lessee's incremental borrowing rate is 5.87 per cent, which reflects the fixed rate at which the lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease.	
At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the rate of 5.87 per cent, which is CU342,017.	
The lessee recognises lease assets and liabilities as follows.	
Right-of-use asset	CU407,017 (CU342,017 + CU50,000 + CU15,000)
Lease liability	CU342,017

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Example 14—Initial and subsequent measurement by a lessee and accounting for a change in the lease term		
Cash (lease payment for first year)		CU50,000
Cash (initial direct costs)		CU15,000
During the first year of the lease, the lessee recognises lease expenses as follows, depending on how the lease is classified.		
<u>If the lease is classified as a Type A lease</u>		
The lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, amortises the right-of-use asset on a straight-line basis.		
Interest expense	CU20,076	(5.87% × CU342,017)
Lease liability		CU20,076
Amortisation expense	CU40,702	(CU407,017 ÷ 10)
Right-of-use asset		CU40,702
At the end of the first year of the lease, the carrying amount of the lessee's right-of-use asset is CU366,315 (CU407,017 – CU40,702).		
<u>If the lease is classified as a Type B lease</u>		
The lessee determines the cost of the lease to be the sum of CU500,000 (sum of the lease payments for the lease term) plus CU15,000 (initial direct costs incurred by the lessee). The annual lease expense to be recognised is therefore CU51,500 (CU515,000 ÷ 10 years).		
Lease expense	CU51,500	
Lease liability		CU20,076 (5.87% × CU342,017)
Right-of-use asset		CU31,424 (CU51,500 – CU20,076)
At the end of the first year of the lease, the carrying amount of the lessee's right-of-use asset is CU375,593 (CU407,017 – CU31,424).		
At the end of the first year of the lease, the lessee's lease liability is CU362,093 (CU342,017 + CU20,076), regardless of how the lease is classified.		
At the beginning of the second year of the lease, the lessee makes the payment for that year, recognised as follows.		
Lease liability	CU50,000	
Cash		CU50,000

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Example 14—Initial and subsequent measurement by a lessee and accounting for a change in the lease term

Part 2—Accounting for a change in the lease term

In the sixth year of the lease, the lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for the lessee at the end of the original non-cancellable period of 10 years. That is because the improvements result in the underlying asset having greater utility to the lessee than alternative assets that could be leased for a similar amount. Consequently, at the end of Year 6, the lessee concludes that it has a significant economic incentive to exercise the option to extend the lease. The lessee's incremental borrowing rate at the end of Year 6, taking into consideration the extended remaining lease term, is 7.83 per cent. Although the lease term changes, the lessee does not reassess the lease classification.

At the end of the sixth year, before accounting for the change in the lease term, the lease liability is CU183,972 (present value of four remaining payments of CU50,000, discounted at the rate of 5.87 per cent). The lessee's right-of-use asset is CU162,806 if the lease is classified as a Type A lease or CU189,971 if the lease is classified as a Type B lease.

The lessee remeasures the lease liability, which is now equal to the present value of four payments of CU50,000 followed by five payments of CU55,000, all discounted at the rate of 7.83 per cent, which is CU355,189. The lessee increases the lease liability by CU171,217 representing the difference between the remeasured liability of CU355,189 and its current carrying amount of CU183,972. The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights, recognised as follows.

Right-of-use asset	CU171,217
Lease liability	CU171,217

Following the adjustment, the carrying amount of the lessee's right-of-use asset is CU334,023 if the lease is a Type A lease (ie CU162,806 + CU171,217) or CU361,188 if the lease is a Type B lease (ie CU189,971 + CU171,217).

The lessee then makes the lease payment for Year 7, recognised as follows.

Lease liability	CU50,000
Cash	CU50,000

Following this payment, the lessee's lease liability is CU305,189 (CU355,189 - CU50,000), regardless of how the lease is classified.

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Example 14—Initial and subsequent measurement by a lessee and accounting for a change in the lease term

The lessee recognises lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

If the lease is classified as a Type A lease at the commencement date

The lessee expects to consume the right-of-use asset's future economic benefits evenly over the remaining lease term and amortises the right-of-use asset on a straight-line basis.

Interest expense	CU23,896 (7.83% × CU305,189)
Lease liability	CU23,896
Amortisation expense	CU37,114 (CU334,023 ÷ 9)
Right-of-use asset	CU37,114

If the lease is classified as a Type B lease at the commencement date

The lessee determines the remaining cost of the lease as follows:

- the sum of CU500,000 (ten payments of CU50,000 during the initial lease term) plus CU275,000 (five payments of CU55,000 during lease extension) plus CU15,000 (initial direct costs incurred by lessee), ie CU790,000; less
- the cost of the lease already recognised as an expense of CU309,000 (annual lease expense of CU51,500 recognised during the first six years of the lease).

The amount of the remaining cost of the lease is therefore CU481,000 (CU790,000 – CU309,000). Consequently, the lessee determines that the annual expense to be recognised is CU53,444 (CU481,000 ÷ remaining lease term of nine years).

Lease expense	CU53,444
Lease liability	CU23,896 (7.83% × CU305,189)
Right-of-use asset	CU29,548 (CU53,444 – CU23,896)

Example 15—Termination penalties

A lessee enters into a 10-year lease of an asset, which it can terminate at the end of each year once the lease enters its sixth year. Lease payments are CU50,000 per year during the 10-year term, payable at the beginning of each year. If the lessee terminates the lease at the end of Year 6, the lessee must pay a penalty to the lessor of CU20,000. The termination penalty decreases by CU5,000 in each successive year.

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Example 15—Termination penalties
<p>At the commencement date, the lessee concludes that it does not have a significant economic incentive not to exercise the termination option in Year 6 (ie the lessee does not have a significant economic incentive to continue to use the underlying asset after Year 6), having considered all factors including the termination penalties and the lease payments during the remaining years of the lease. Accordingly, the lessee determines that the lease term is six years.</p> <p>At the commencement date, the lessee measures the lease liability on the basis of lease payments of CU50,000 for six years plus the penalty of CU20,000 payable at the end of Year 6.</p>

Lessee accounting for purchase options

IE9 The following example illustrates how a lessee accounts for a lease when the lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

Example 16—Purchase option				
<p>A lessee enters into a five-year lease of equipment with annual lease payments of CU59,000, payable at the end of each year. This example ignores any initial direct costs. At the end of Year 5, the lessee has an option to purchase the equipment for CU5,000. The residual value of the equipment in five years is CU75,000. Consequently, the lessee concludes that it has a significant economic incentive to exercise the purchase option. The fair value of the equipment at the commencement date is CU250,000, and its useful life is seven years.</p> <p>The rate that the lessor charges the lessee in this example is the rate implicit in the lease, which is 6.33 per cent. That is the rate that causes the present value of lease payments, including the exercise price of the purchase option, to equal the fair value of the equipment at the commencement date.</p> <p>The lessee classifies the lease as a Type A lease.</p> <p>The lessee measures the lease liability at the commencement date at CU250,000 (the present value of five payments of CU59,000 plus the present value of the purchase option payment of CU5,000).</p> <p>At the commencement date, the lessee recognises lease assets and liabilities as follows.</p> <table> <tbody> <tr> <td>Right-of-use asset</td> <td>CU250,000</td> </tr> <tr> <td>Lease liability</td> <td>CU250,000</td> </tr> </tbody> </table>	Right-of-use asset	CU250,000	Lease liability	CU250,000
Right-of-use asset	CU250,000			
Lease liability	CU250,000			

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Example 16—Purchase option

The lessee amortises the right-of-use asset over the useful life of the equipment of seven years, and not over the lease term of five years, because the lessee has a significant economic incentive to exercise the purchase option. The lessee expects to consume the asset's future economic benefits evenly over the seven years and, thus, amortises the asset on a straight-line basis.

During the first year of the lease, the lessee recognises interest on the lease liability and amortisation of the right-of-use asset as follows.

Interest expense	CU15,825	(6.33% × CU250,000)
Lease liability	CU15,825	
Amortisation expense	CU35,714	(CU250,000 ÷ 7)
Right-of-use asset	CU35,714	

At the end of Year 1, the right-of-use asset is CU214,286 (CU250,000 – CU35,714) and the lease liability is CU206,825 (CU250,000 + CU15,825 – CU59,000).

At the end of Year 5, the lessee has amortised the right-of-use asset to CU71,430 (CU250,000 – CU35,714 × 5) and has a liability of CU5,000 relating to the purchase option. The lessee exercises the option to purchase the equipment and settles the remaining liability. The lessee then reclassifies the right-of-use asset and recognises the item of equipment as follows.

Lease liability	CU5,000	
Cash	CU5,000	
Property, plant and equipment	CU71,430	
Right-of-use asset ^(a)	CU71,430	

(a) The lessee could choose to present the right-of-use asset as part of property, plant and equipment during the five-year term of the lease; alternatively, the lessee could choose to present the right-of-use asset separately from property, plant and equipment.

Lessee accounting for variable lease payments

IE10 The following example illustrates variable lease payments that are in-substance fixed lease payments.

Example 17—Variable lease payments that are in-substance fixed lease payments

Example 17A: A lessee enters into a five-year lease of property, with annual payments determined as 2 per cent of the lessee's sales generated from the leased property. The annual lease payment must be at least CU100,000 in each year of the lease.

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Example 17—Variable lease payments that are in-substance fixed lease payments	
	<p>At the commencement date, the lessee measures the lease liability on the basis of annual fixed payments of CU100,000. The lessee is required to make payments of at least CU100,000 in each year, regardless of the level of sales from the property. Accordingly, those payments are in-substance fixed lease payments.</p> <p><i>Example 17B: A lessee enters into a five-year lease of property, with an initial annual payment of CU100,000. The contract includes an escalation clause specifying that the lease payment for each year (excluding the first year of the lease) will increase by the higher of the annual increase in the Consumer Price Index for the preceding 12 months, or 2 per cent.</i></p> <p>At the commencement date, the lessee measures the lease liability on the basis of fixed lease payments of CU100,000 in Year 1, CU102,000 in Year 2, CU104,040 in Year 3, CU106,121 in Year 4 and CU108,243 in Year 5. The lessee is required to make payments of at least those amounts in each year during the lease term, regardless of the movement in the Consumer Price Index. Accordingly, those payments are in-substance fixed lease payments.</p> <p><i>Example 17C: A lessee enters into a 10-year lease of property, with annual fixed lease payments of CU100,000 and variable lease payments that are determined as 3 per cent of the lessee's sales from the property. At the end of the 10-year period, if sales from the property are at least CU1,000,000 in each of the 10 years, the lessee has the option to purchase the property for CU375,000 (at the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the purchase option). However, if sales from the property are less than CU1,000,000 in any of the 10 years of the lease, the lessee is required to purchase the property for CU375,000 at the end of the 10-year period.</i></p> <p>At the commencement date, the lessee measures the lease liability at the present value of either of the following:</p> <ul style="list-style-type: none"> (a) yearly payments of CU130,000 (the CU100,000 annual fixed payment plus CU30,000 variable payment assuming sales are CU1,000,000); or (b) fixed annual payments of CU100,000 plus the CU375,000 purchase price payable at the end of Year 10. <p>The exercise price of the purchase option of CU375,000, or the annual payments of CU30,000 for 10 years, are considered to be in-substance fixed payments because the lessee is required to pay at least the lower of those two amounts, regardless of the level of sales during the 10-year lease term.</p>

IE11 The following example illustrates how a lessee would account for variable lease payments that depend on an index or a rate and variable lease payments that are linked to performance.

Example 18—Variable lease payments dependent on an index and variable lease payments linked to performance

Example 18A: A lessee enters into a 10-year lease of property with annual lease payments of CU100,000, payable at the beginning of each year. The contract specifies that lease payments for each year will increase on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. This example ignores any initial direct costs. The lease is classified as a Type B lease.

The rate the lessor charges the lessee is not readily determinable. The lessee's incremental borrowing rate is 8 per cent, which reflects the rate at which the lessee could borrow a similar amount in the same currency, for the same term and with similar collateral as in the lease.

At the commencement date, the lessee makes the lease payment for the first year and measures the lease liability at CU624,689 (the present value of nine payments of CU100,000 discounted at the rate of 8 per cent).

The lessee recognises lease assets and liabilities as follows.

Right-of-use asset	CU724,689 (CU624,689 + CU100,000)
Lease liability	CU624,689
Cash (lease payment for first year)	CU100,000

The lessee determines the cost of the lease to be CU1,000,000 (the lease payments for the lease term). The annual lease expense to be recognised is CU100,000 (CU1,000,000 ÷ 10 years).

Lease expense	CU100,000
Lease liability	CU49,975 (8% × CU624,689)
Right-of-use asset	CU50,025 (CU100,000 – CU49,975)

At the end of the first year of the lease the Consumer Price Index is 128. The lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be CU102,400 (CU100,000 × 128 ÷ 125).

Because the lease payments are variable payments that depend on an index, the lessee adjusts the lease liability to reflect the Consumer Price Index rate at the end of the reporting period, ie the lease liability now reflects annual lease payments of CU102,400. The lessee does not reassess the discount rate because a change in variable lease payments that depend on an index does not require the discount rate to be reassessed.

The lessee's adjustment to the lease liability is the difference between the present value of the revised and the original lease payments, discounted using the rate determined at the commencement date, ie the present value of nine payments of CU2,400 payable at the beginning of the period, discounted at the rate of 8 per cent, which equals CU16,192. The lessee determines that all of the remeasurement relates to future periods and adjusts the carrying amount of the right-of-use asset as follows.

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Example 18—Variable lease payments dependent on an index and variable lease payments linked to performance	
Right-of-use asset	CU16,192
Lease liability	CU16,192
At the beginning of the second year of the lease, the lessee makes the lease payment for the year and recognises the following.	
Lease liability	CU102,400
Cash	CU102,400
<i>Example 18B:</i> Assume the same facts as Example 18A except that the lessee also is required to make variable lease payments for each year of the lease, which are determined as 2 per cent of the lessee's sales generated from the leased property.	
At the commencement date, the lessee measures the lease assets and liabilities recognised at the same amounts as in Example 18A because the variable lease payments are linked to performance (ie those payments are variable lease payments that neither depend on an index or a rate nor are in-substance fixed payments). Accordingly, the lessee does not include the variable lease payments determined as a percentage of sales in the measurement of the lease liability or right-of-use asset.	
Right-of-use asset	CU724,689 (CU624,689 + CU100,000)
Lease liability	CU624,689
Cash (lease payment for first year)	CU100,000
The lessee prepares financial statements on an annual basis. The lessee determines the cost of the lease to be CU1,000,000 (the lease payments for the lease term). The annual lease expense to be recognised is therefore CU100,000 (CU1,000,000 ÷ 10 years). During the first year of the lease, the lessee generates sales of CU1,200,000 from the leased property, incurring an additional lease expense of CU24,000 (2% × CU1,200,000).	
Lease expense	CU124,000 (CU100,000 + CU24,000)
Lease liability	CU49,975 (8% × CU624,689)
Right-of-use asset	CU50,025 (CU100,000 – CU49,975)
Accrued variable lease payments/cash	CU24,000
At the end of the first year of the lease, the lessee would remeasure the lease liability consistently with Example 18A. Consequently, the lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be CU102,400 and adjusts the lease liability and right-of-use asset by CU16,192.	

Lessor measurement for Type A leases

IE12 The following examples illustrate how a lessor would account for Type A leases.

Example 19—Lessor accounting for Type A leases—the carrying amount of the underlying asset equals fair value

A lessor leases a vehicle for three years for lease payments of CU2,400, payable annually at the end of each year, and incurs initial direct costs of CU200. At the commencement date, the carrying amount and fair value of the vehicle is CU10,000 and the amount the lessor expects to derive from the vehicle following the end of three years is CU4,500. The lessee has an option to purchase the vehicle at the end of the initial lease term at a market price or to extend the lease for two years for the same annual payment of CU2,400. The economic life of the vehicle is seven years.

The lessor concludes that the lessee does not have a significant economic incentive to extend the lease or exercise the purchase option and therefore determines the lease term to be three years. The lessor also determines that the lease is a Type A lease.

The rate that the lessor charges the lessee is the rate implicit in the lease, which is 6.87 per cent (ie it is the rate that causes the present value of the lease payments and the estimated value of the vehicle at the end of the lease term to equal the fair value of the vehicle at the commencement date).

The lessor measures the lease receivable at CU6,513, which is the present value of three payments of CU2,400, discounted at 6.87 per cent, plus the initial direct costs of CU200.

The lessor measures the gross residual asset at CU3,687, which is the present value of the amount the lessor expects to derive from the vehicle following the end of the lease term of CU4,500, discounted at 6.87 per cent.

Because there is no difference between the carrying amount and the fair value of the vehicle at the commencement date, the lessor does not recognise any profit at that date or any unearned profit relating to the residual asset. The lessor therefore recognises the residual asset at CU3,687.

At the commencement date, the lessor derecognises the vehicle and recognises the lease receivable and residual asset as follows.

Lease receivable	CU6,513	
Residual asset	CU3,687	
Vehicle		CU10,000
Cash/payable for initial direct costs		CU200

The lessor also may present revenue and cost of goods sold at CU6,313 at the commencement date, depending on the lessor's business model.

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Example 19—Lessor accounting for Type A leases—the carrying amount of the underlying asset equals fair value																																									
<p>Because the initial direct costs are included in the receivable, the lessor determines the imputed rate that will reduce the balance of the lease receivable to CU0 at the end of the lease term. The imputed rate for the lease is 5.18 per cent. The imputed rate is used to determine the interest income on the lease receivable in each year of the lease.</p> <p>At the end of Year 1, the lessor recognises the receipt of a lease payment, interest on the lease receivable, and interest on the residual asset as follows.</p> <table border="0"> <tr> <td>Cash</td> <td>CU2,400</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td> Lease receivable</td> <td></td> <td>CU2,400</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>Lease receivable</td> <td>CU338 (5.18% × CU6,513)</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>Residual asset</td> <td>CU253 (6.87% × CU3,687)</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td> Interest income</td> <td></td> <td>CU591 (CU338 + CU253)</td> <td></td> <td></td> <td></td> <td></td> </tr> </table> <p>Following those entries, the carrying amount of the lease receivable is CU4,451 (CU6,513 – CU2,400 + CU338), and the carrying amount of the residual asset is CU3,940 (CU3,687 + CU253).</p> <p>The lessor accounts for the lease during the remainder of the lease term as follows.</p>							Cash	CU2,400						Lease receivable		CU2,400					Lease receivable	CU338 (5.18% × CU6,513)						Residual asset	CU253 (6.87% × CU3,687)						Interest income		CU591 (CU338 + CU253)				
Cash	CU2,400																																								
Lease receivable		CU2,400																																							
Lease receivable	CU338 (5.18% × CU6,513)																																								
Residual asset	CU253 (6.87% × CU3,687)																																								
Interest income		CU591 (CU338 + CU253)																																							
Statement of financial position		Statement of profit or loss and other comprehensive income																																							
<i>End of Year</i>	<i>Lease receivable</i>	<i>Gross residual asset</i>	<i>Carrying amount of residual asset</i>	<i>Interest on lease receivable</i>	<i>Interest on residual asset</i>	<i>Interest income</i>																																			
1	4,451	3,940	3,940	338	253	591																																			
2	2,282	4,211	4,211	231	271	502																																			
3	–	4,500	4,500	118	289	407																																			
<p>At the end of the lease term, the lessor reclassifies the residual asset to, for example, inventory.</p> <table border="0"> <tr> <td>Inventory</td> <td>CU4,500</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td> Residual asset</td> <td></td> <td>CU4,500</td> <td></td> <td></td> <td></td> <td></td> </tr> </table> <p>The vehicle is then sold for CU5,000, and the lessor recognises the sale.</p> <table border="0"> <tr> <td>Cash/accounts receivable</td> <td>CU5,000</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td> Inventory</td> <td></td> <td>CU4,500</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td> Gain on sale of inventory</td> <td></td> <td>CU500</td> <td></td> <td></td> <td></td> <td></td> </tr> </table>							Inventory	CU4,500						Residual asset		CU4,500					Cash/accounts receivable	CU5,000						Inventory		CU4,500					Gain on sale of inventory		CU500				
Inventory	CU4,500																																								
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Inventory		CU4,500																																							
Gain on sale of inventory		CU500																																							

Example 20—Lessor accounting for Type A leases—the carrying amount of the underlying asset is lower than fair value

Assume the same facts as in Example 19 except that the carrying amount of the vehicle at the commencement date is CU7,500 and any initial direct costs are ignored in this example.

The lessor measures the lease receivable in the same way as in Example 19, except that this example ignores initial direct costs (CU200); ie the lease receivable at the commencement date is CU6,313 (CU6,513 – CU200).

The lessor measures the gross residual asset in the same way as in Example 19 (ie at the present value of the amount the lessor expects to derive from the vehicle following the end of the lease term, which is CU3,687). To calculate both the recognised and the unearned profit, the lessor first determines the difference between the fair value and the carrying amount of the vehicle to be CU2,500 (CU10,000 – CU7,500). The lessor calculates the profit recognised at the commencement date on the basis of the present value of the lease payments as a proportion of the fair value of the vehicle as CU1,578 ((CU10,000 – CU7,500) × (CU6,313 ÷ CU10,000)). Accordingly, the lessor calculates the unearned profit on the residual asset as CU922 (CU2,500 – CU1,578).

At the commencement date, the lessor derecognises the vehicle and recognises the lease receivable, gross residual asset and unearned profit on the residual asset, as well as profit on the lease as follows.

Lease receivable	CU6,313	
Revenue ^(a)		CU6,313
Gross residual asset ^(b)	CU3,687	
Cost of goods sold ^(a)	CU4,735 (CU7,500 – CU3,687 + CU922)	
Unearned profit on the residual asset ^(b)		CU922
Vehicle		CU7,500

At the end of Year 1, the lessor recognises the receipt of a lease payment, interest on the lease receivable, and interest on the gross residual asset as follows.

Cash	CU2,400	
Lease receivable		CU2,400
Lease receivable	CU434 (6.87% ^(c) × CU6,313)	
Residual asset	CU253 (6.87% × CU3,687)	
Interest income		CU687 (CU434 + CU253)

Following those entries, the carrying amount of the lease receivable is CU4,347 (CU6,313 – CU2,400 + CU434), and the carrying amount of the net residual asset is CU3,018 (CU3,687 – CU922 + CU253).

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Example 20—Lessor accounting for Type A leases—the carrying amount of the underlying asset is lower than fair value						
The lessor accounts for the lease during the remainder of the lease term as follows.						
Statement of financial position				Statement of profit or loss and other comprehensive income		
<i>End of Year</i>	<i>Lease receivable</i>	<i>Gross residual asset</i>	<i>Unearned profit on residual asset</i>	<i>Carrying amount of residual asset</i>	<i>Interest on lease receivable</i>	<i>Interest on residual asset</i>
1	4,347	3,940	(922)	3,018	434	253
2	2,246	4,211	(922)	3,289	299	271
3	–	4,500	(922)	3,578	154	289
At the end of the lease term, the lessor reclassifies the residual asset to, for example, inventory.						
Inventory				CU3,578		
Unearned profit				CU922		
Residual asset				CU4,500		
The vehicle is then sold for CU5,000, and the lessor recognises the sale.						
Cash/accounts receivable				CU5,000		
Cost of sales				CU3,578		
Inventory				CU3,578		
Revenue				CU5,000		
(a) This example illustrates a gross presentation of profit on the lease at the commencement date. If a net presentation best reflects the lessor's business model, the lessor would present a gain of CU1,578 (CU6,313 – CU4,735) instead of separately presenting revenue and cost of goods sold.						
(b) Not required to be presented or disclosed as two amounts but only required to be presented on a net basis.						
(c) This rate is different from the rate applied to the lease receivable in Example 19 because the lease receivable in this example does not include any initial direct costs.						

IE13 The following example illustrates how a lessor would account for a residual value guarantee for Type A leases.

Example 21—Lessor accounting for Type A leases—residual value guarantees
Assume the same facts as Example 19 and, in addition, the lessee guarantees the residual value of the vehicle.

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Example 21—Lessor accounting for Type A leases—residual value guarantees

Example 21A: According to the residual value guarantee, if the market value of the vehicle at the end of the lease term is lower than CU4,500, the lessee will compensate the lessor for the difference. The lessor will obtain the benefits if the market value is in excess of CU4,500.

At the commencement date, the lessor does not recognise the residual value guarantee as part of the lease receivable. If, during the lease term, the amount the lessor expects to derive from the vehicle following the end of the lease term falls below the original estimate of CU4,500, the lessor would not recognise any impairment of the residual asset (assuming no deterioration in the lessee's credit standing). That is because the original amount expected to be derived from the vehicle of CU4,500 will be recovered through the residual value guarantee.

Example 21B: In addition to the guarantee provided by the lessee in Example 21A, the contract also states that, if the vehicle is sold for more than CU4,500, after the end of the lease the lessor will pay the difference between the selling price and CU4,500 to the lessee.

In this example, CU4,500 is considered to be a fixed lease payment structured as a residual value guarantee. Accordingly, the lessor includes CU4,500, discounted using the rate implicit in the lease, as part of the lease receivable at the commencement date.

IE14 The following example illustrates how a lessor would measure an impairment of the lease receivable for Type A leases.

Example 22—Lessor accounting for Type A leases—impairment of the lease receivable*Part 1: Impairment of the lease receivable*

This example illustrates the measurement of any impairment loss and allowance for expected credit losses but does not consider the timing of recognition of impairment of the lease receivable. The timing of recognition would be determined in accordance with the requirements for financial instruments. For the purpose of this example, it is assumed that the lessor is required to recognise an impairment allowance equal to the full expected credit losses for the lease receivable at the end of Year 2 of the lease. The lessor may have already recognised an impairment allowance before this date in accordance with the requirements for financial instruments, which is ignored in this example.^(a)

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Example 22—Lessor accounting for Type A leases—impairment of the lease receivable						
<p>A lessor leases a vehicle for three years for lease payments of CU2,400, payable annually at the beginning of each year. At the commencement date, the carrying amount of the vehicle is CU7,500, the fair value of the vehicle is CU10,000, and the amount the lessor expects to derive from the vehicle following the end of three years is CU4,500. The rate implicit in the lease is 9.64 per cent.</p> <p>At the start of the lease, the lessor would expect to account for the lease as follows before accounting for expected credit losses.</p>						
Statement of financial position				Statement of profit or loss and other comprehensive income		
<i>End of Year</i>	<i>Lease receivable</i>	<i>Gross residual asset</i>	<i>Unearned profit on residual asset</i>	<i>Carrying amount of residual asset</i>	<i>Interest on lease receivable and residual asset</i>	<i>Profit on the lease</i>
0	6,586	3,414	(854)	2,560	—	1,646
1	4,589	3,744	(854)	2,890	733	—
2	2,400	4,104	(854)	3,250	571	—
3	—	4,500	(854)	3,646	396	—
<p>At the end of Year 2, the lessor measures the allowance for expected credit losses on the lease receivable in accordance with the requirements for financial instruments.</p> <p>In accordance with the terms and conditions of the lease agreement, the lessor is entitled to retrieve the vehicle if the lessee fails to make the final lease payment at the beginning of Year 3, ie the vehicle provides collateral against the receivable.</p> <p>At the end of Year 2, the lessor estimates that it would be able to sell the vehicle for CU5,500 if the vehicle were to be retrieved at the beginning of Year 3. The amount the lessor expects to derive from the vehicle following the end of the lease term remains unchanged at CU4,500.</p>						

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Example 22—Lessor accounting for Type A leases—impairment of the lease receivable

When measuring the impairment allowance, the lessor allocates the expected cash flows from the sale of the collateral between the lease receivable and the residual asset. The portion of the collateral allocated to the residual asset represents the cash flows that the lessor expects to derive from the vehicle following the end of the lease term (ie CU4,104, representing the present value of CU4,500), and the portion allocated to the lease receivable represents the cash flows that the lessor expects to derive during the remaining lease term (ie CU1,396, calculated as CU5,500 less CU4,104).

Accordingly, at the end of Year 2 the lessor recognises an impairment allowance on the lease receivable of CU1,004 (ie CU2,400, the carrying amount of the lease receivable less CU1,396, the portion of the collateral allocated to the lease receivable). The amount of impairment recognised in profit or loss would represent the difference between the impairment allowance of CU1,004 at the end of Year 2 and the amount of the impairment allowance already recognised in accordance with the requirements for financial instruments. The lessor does not recognise any impairment on the residual asset because the lessor expects to derive economic benefits from the residual asset that exceed the carrying amount of that asset.

Part 2: Return of the underlying asset

The lessee fails to pay the final lease payment at the beginning of Year 3. The lessor retrieves the vehicle from the lessee and sells it for CU5,500.

The lessor recognises the vehicle at CU4,646, ie the carrying amount of the lease receivable (CU1,396) and the residual asset (CU3,250).

Inventory	CU4,646
Lease receivable	CU1,396
Residual asset	CU3,250

The vehicle is then sold for CU5,500, and the lessor recognises the sale:

Cash/accounts receivable	CU5,500
Inventory	CU4,646
Gain on sale of inventory	CU854

(a) Both the FASB Proposed Update *Accounting for Credit Losses on Certain Financial Instruments* and the IASB Exposure Draft *Financial Instruments: Expected Credit Losses* propose that existing recognition thresholds be removed. This means that a lessor would always account for expected credit losses on lease receivables and recognition would no longer be contingent on impairment losses being 'probable' or there being objective evidence of impairment. The FASB Proposed Update and the IASB Exposure Draft propose different models that result in the recognition of different loss allowance amounts at different times. For purposes of this example, it is assumed that the lessor is required to recognise an impairment allowance equal to the full expected credit losses on the lease receivable at the end of Year 2.

Sale and leaseback transaction

IE15 The following example illustrates how a lessee and a lessor would account for a sale and leaseback transaction.

Example 23—Sale and leaseback transaction	
<p>An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for cash of CU2,000,000. Immediately before the transaction, the land is carried at a cost of CU1,000,000. At the same time, Seller enters into a contract with Buyer for the right to use the land for 10 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that Buyer obtains control of the land in accordance with the requirements for determining when a performance obligation is satisfied in [draft] IFRS X <i>Revenue from Contracts with Customers</i>. Accordingly, Seller and Buyer account for the transaction as a sale and leaseback. This example ignores any initial direct costs associated with the transaction.</p>	
<p>The market rates for the lease of the land are CU90,000, payable annually at the end of each year. Because the consideration for the sale of the land is not at fair value, Seller and Buyer are required to make adjustments to recognise the transaction at fair value.</p>	
<p>The rate the lessor charges the lessee is 5 per cent. This rate is readily determinable by Seller. The lease is classified as a Type B lease.</p>	
<p>At the commencement date, Seller accounts for the transaction as follows.</p>	
<p>Leaseback of the land recognised using the market rates for the lease.</p>	
Right-of-use asset	CU694,956
Lease liability	CU694,956 (10 payments of CU90,000, discounted at 5%)
<p>Sale of the land (adjusted to account for the lease using market rates):</p>	
Cash	CU2,000,000
Land	CU1,000,000
Financial liability	CU231,652 (10 payments of CU30,000, discounted at 5%)
Gain on sale of land	CU768,348
<p>At the commencement date, Buyer accounts for the transaction as follows.</p>	
Land	CU1,768,348 (CU2,000,000 – CU231,652)
Financial asset	CU231,652 (10 payments of CU30,000, discounted at 5%)
Cash	CU2,000,000

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Example 23—Sale and leaseback transaction

After the commencement date, both Seller and Buyer account for the lease by treating CU90,000 of the annual payments of CU120,000 as lease payments. The remaining CU30,000 of annual payments made by Seller are accounted for as payments made to settle the financial liability of CU231,652 (recognised by Seller) and payments received to settle the financial asset of CU231,652 (recognised by Buyer).

Lessee transition—operating lease to Type A lease

IE16 The following example illustrates how a lessee would account for the transition of existing operating leases to Type A leases when applying the permitted alternative to a full retrospective transition approach.

Example 24—Lessee transition—operating lease to Type A lease

A lessee enters into a five-year lease of a vehicle on 1 January 20X1 with annual lease payments payable at the end of each year. The lessee originally accounts for the lease as an operating lease. On 1 January 20X2 (and before transition adjustments), the lessee has an accrued rent liability of CU1,200 for the lease, reflecting rent that was previously recognised as an expense but was not paid at that date. Four lease payments remain: one payment of CU31,000 followed by three payments of CU33,000.

1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in this [draft] Standard. At the effective date, the lessee's incremental borrowing rate is 6 per cent. The lessee classifies the lease of the vehicle as a Type A lease.

On 1 January 20X2, the lessee measures the lease liability at CU112,462, the present value of one payment of CU31,000 and three payments of CU33,000, discounted at 6 per cent.

The lessee determines the carrying amount of the right-of-use asset at the date of initial application in two steps: the lessee estimates the commencement-date lease liability, and it calculates the right-of-use asset (before adjustment for accrued rent) on the basis of the proportion of the commencement-date lease liability that relates to the remaining lease term. The lessee elects not to include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.

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Example 24—Lessee transition—operating lease to Type A lease		
<p>The lessee estimates the commencement-date lease liability on the basis of the average remaining lease payments. The average lease payment for the remaining four years of the lease is CU32,500. The lessee estimates the commencement-date lease liability at CU136,902 (the present value of a CU32,500 annuity for the five-year total term of the lease). Thus, the lessee measures the right-of-use asset before adjustment for accrued rent at CU109,522 (CU136,902 × four remaining years ÷ five-year lease term).</p> <p>The difference between the right-of-use asset and the lease liability on 1 January 20X2 is an adjustment to opening retained earnings at that date.</p> <p>In summary, on 1 January 20X2, the lessee recognises the following to reflect the transition of the operating lease to a Type A lease.</p>		
Right-of-use asset	CU109,522	
Retained earnings	CU2,940	
Lease liability		CU112,462
<p>The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognised accrued rent.</p>		
Accrued rent	CU1,200	
Right-of-use asset		CU1,200

Lessee transition—operating lease to Type B lease

- IE17 The following example illustrates lessee accounting for the transition of existing operating leases to Type B leases when applying the permitted alternative to a full retrospective transition approach.

Example 25—Lessee transition—operating lease to Type B lease	
<p>A lessee enters into a five-year lease of land on 1 January 20X1 with annual lease payments payable at the end of each year. The lessee originally accounts for the lease as an operating lease. On 1 January 20X2 (and before transition adjustments), the lessee has an accrued rent liability of CU1,200 for the lease, reflecting rent that was previously recognised as an expense but was not paid at that date. Four lease payments remain: one payment of CU31,000 followed by three payments of CU33,000.</p> <p>1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in this [draft] Standard. At the effective date, the lessee's incremental borrowing rate is 6 per cent. The lessee classifies the lease of land as a Type B lease.</p>	

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Example 25—Lessee transition—operating lease to Type B lease

On 1 January 20X2, the lessee measures the lease liability at CU112,462, the present value of one payment of CU31,000 and three payments of CU33,000, discounted using the rate of 6 per cent.

The right-of-use asset is equal to the lease liability before adjustment for accrued rent. The lessee does not include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.

In summary, on 1 January 20X2, the lessee recognises the following to reflect the transition of the operating lease to a Type B lease.

Right-of-use asset	CU112,462
Lease liability	CU112,462

The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognised accrued rent.

Accrued rent	CU1,200
Right-of-use asset	CU1,200

Lessor transition—operating lease to Type A lease

IE18 The following example illustrates lessor accounting for the transition of existing operating leases to Type A leases when applying the permitted alternative to a full retrospective transition approach.

Example 26—Lessor transition—operating lease to Type A lease

A lessor leases a vehicle for five years on 1 January 20X1 with annual lease payments receivable at the end of each year. The lessor originally accounts for the lease as an operating lease. On 1 January 20X2 (and before transition adjustments), the lessor has a rent accrual of CU1,200 for the lease, reflecting rent that was previously recognised as income but was not received at that date. Four lease payments remain: one payment of CU31,000 followed by three payments of CU33,000.

1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessor first applies the requirements in this [draft] Standard. On 1 January 20X2, the lessor classifies the lease of the vehicle as a Type A lease. Immediately before 1 January 20X2, the vehicle was recognised in the lessor's financial statements at CU176,000 (historical cost of CU200,000 – depreciation of CU24,000). The lessor also has an asset for accrued rent of CU1,200.

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Example 26—Lessor transition—operating lease to Type A lease

The rate implicit in the lease at the commencement date is 5.27 per cent. The fair value of the vehicle on 1 January 20X2 is CU180,000, and the expected value of the vehicle at the end of the lease term is CU80,000. The present value of one payment of CU31,000 plus 3 payments of CU33,000, discounted using the rate of 5.27 per cent, is CU114,390. The present value of the expected value of the vehicle at the end of the lease term, discounted using the rate of 5.27 per cent, is CU65,147.

The lessor determines the residual asset on the basis of information available on 1 January 20X2. The lessor determines that profit of CU1,779 relates to the lease ((CU180,000 fair value of the vehicle - CU177,200 carrying amount of the vehicle immediately before 1 January 20X2 after adjustment for accrued rent) × (CU114,390 (the lease receivable) ÷ CU180,000 (the fair value of the vehicle)). The lessor determines the unearned profit relating to the residual asset as CU1,021 at 1 January 20X2 (CU180,000 fair value of the vehicle - CU177,200 carrying value of the vehicle after adjustment for accrued rent - CU1,779 profit relating to the lease). The net residual asset of CU64,126 comprises the gross residual asset of CU65,147 and the unearned profit on the residual asset of CU1,021.

The difference between the assets previously recognised (vehicle of CU176,000 and accrued rent of CU1,200) and the assets recognised at 1 January 20X2 (lease receivable of CU114,390 and net residual asset of CU64,126) is a transition adjustment to opening retained earnings at 1 January 20X2 of CU1,316.

In summary, at 1 January 20X2, the lessor recognises the following to reflect the transition of the operating lease to a Type A lease.

Lease receivable	CU114,390	
Gross residual asset ^(a)	CU65,147	
Accumulated depreciation	CU24,000	
Vehicle		CU200,000
Unearned profit on the residual asset ^(a)		CU1,021
Accrued rent		CU1,200
Retained earnings		CU1,316

(a) Not required to be presented or disclosed as two amounts but only required to be presented on a net basis.