HKFRS 16 LEASES

Learning Objectives

After reading this chapter, you should be able to:

1. Define lease and determine whether a contract contains a lease;
2. Understand the concept of lease term;
3. Identify lease payments, including fixed payments, variable payments and the residual value guarantees;
4. Understand the concept of discount rate, including rate implicit in the lease and incremental borrowing rate;
5. Account for leases in the books of the lessee, including the initial and subsequent measurement of right-of-use assets and lease liabilities;
6. Understand the recognition exemptions from the perspective of the lessee;
7. Classify leases into operating and finance leases from the perspective of lessor;
8. Account for finance leases and operating leases in the books of lessor;
9. Describe the key disclosure requirements for leases in the books of lessee and lessor.

Leasing is an important activity for many entities. A retail and consumer product entity may lease its retail space (for example in a shopping mall) for selling its products. Manufacturing entities may enter into contracts to rent their manufacturing plants and equipment, warehouses as well as fleet arrangements as their distribution network.

The reason why leasing is common because it provides a means of gaining access to assets and at the same time it reduces an entity's exposure to the risks of asset ownership. Due to its prominence in businesses, it is crucial to have a complete and understandable picture of an entity’s leasing activities.

Hong Kong Financial Reporting Standard ("HKFRS") 16 *Leases* sets out the framework for how a lease transaction should be dealt with, from both the perspectives of a lessee and lessor. HKFRS 16 supersedes Hong Kong Accounting Standard ("HKAS") 17 *Leases*.

This chapter will first introduce what a lease is from the accounting perspective, followed by a technical discussion of the lessee and lessor accounting and a brief description of the key disclosure requirements for leases.

1. IDENTIFYING A LEASE

Definitions

Lease

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

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.*

At the inception of the lease, an entity needs to assess whether the contract contains a lease. This is critical as it determines whether HKFRS 16 is applicable to the transaction. This assessment can be analysed based on the definition of a lease in HKFRS 16:

The following discussion focuses on the two issues highlighted above.

1.1 Issue 1: Is there an identified asset?

Whether there is an identified asset is fundamental to the definition of a lease. An asset is usually identified by being explicitly specified in a contract; therefore, under most of the cases, this analysis is straightforward. However, the terms of some contracts may allow a supplier to substitute the asset with another (for example, the landlord can relocate a tenant to another floor in an office building to accommodate a new tenant). In these cases, it is critical to assess whether the supplier's substitution rights are substantive at inception of the contract. If a supplier has the substantive rights to substitute the asset throughout the period of use, then a customer does *not* have the right to use an identified asset. This brings a further issue on how to determine whether a supplier's right to substitute an asset is substantive or not.

A supplier's right to substitute an asset is substantive only if *both* of the following conditions exist:

(i) the supplier has the practical ability to substitute alternative asset throughout the period of use;

This is usually fulfilled when the customer cannot prevent the supplier from substituting the asset and at the same time when alterative assets are readily available to the supplier.

(ii) the supplier would benefit economically from the exercise of its right to substitute the asset.

This will usually involve an assessment on whether the economic benefits associated with substituting the asset are expected to exceed its costs. One of the important factors for such assessment will be the physical location of the asset. If the asset is located at the customer's premises, the costs associated with substitution are generally higher than when it is located at the supplier's premises. Under such circumstances, the costs are more likely to exceed the benefits associated with substituting the asset and therefore the supplier will be less likely to benefit economically from the exercise of its right to substitute the asset. It can then be concluded that the supplier's right to substitute the asset is *not* substantive.

As an illustration, a contract to lease a forklift truck might give the lessor the right to substitute the asset for another similar asset at any point during the contract term. If the lessor: (i) has the practical ability to substitute the asset (for example, the contract allows substitution and that the lessor owns a large pool of similar forklift trucks); *and* (ii) would benefit economically from the substitution (for example the lessor can substitute the forklift for little or no cost and can lease the replaced asset to another customer for an appropriate consideration), there would be a strong indication of the existence of substantive substitution rights.

HKFRS 16 however states that, under certain circumstances, the supplier's right to substitute the asset does *not* preclude the customer from having the right to use an identified asset. In other words, although a supplier may substitute an identified asset, such right is *not* substantive. Examples include:

- substitute the asset for repairs and maintenance (for example, changing the vehicle when it has to be repaired);
- substitute the asset if it is not operating properly (for example, changing the photocopier under a warranty provision);
- substitute the asset if a technical upgrade becomes available.

1.2 Issue 2: Does the contract convey the right to use an identified asset (concluded from Issue 1)?

In order to assess whether a contract conveys the right to use an identified asset, the key factor is to determine whether the customer (i.e. the lessee) *controls* the use of an identified asset. This in turn depends on whether, throughout the period of use, the customer (i.e. the lessee) has *both* the following:

(i) the right to obtain substantially all of the economic benefits from use of the identified asset; and

(ii) the right to direct the use of the identified asset.

1.2.1 Right to obtain substantially all of the economic benefits from use of asset

The economic benefits from use of asset include:

- primary output (i.e. goods or services) and by-products;
- potential cash flows derived from the primary output or by-products, for example, through sales of such goods; and
- benefits from using the asset that could be realised from a commercial transaction with a third party, for example, through sub-leasing the asset to another party.

To put it in simple terms, if a customer (i.e. a lessee) has an exclusive use of the asset throughout that period or a customer is able to use, hold or sublease the asset, this criterion is generally fulfilled.

1.2.2 Right to direct the use of the identified asset

It is important to differentiate: (i) a lease contract that conveys right to direct the use of an identified asset to lessee (accounted for under HKFRS 16) from (ii) a supply contract that provides services to customer (accounted for under HKFRS 15 *Revenue from Contracts with Customers*). Prior to making an assessment whether a customer has a right to direct the use of the identified asset, it is important to first understand that there are two levels of decision-making rights:

(i) "How and for what purpose" decisions

These are the decision-making rights that are most relevant to changing how and for what purpose the asset is used. These decisions are similar to those made by the board of directors. Examples include:

- Right to change the type of output that is produced by the asset (for example, to decide whether to use a shipping container to transport goods or for storage)
- Right to change when the output is produced

- Right to change where the output is produced

- Right to change whether the output is produced and the quantity of that output.

(ii) Operating decisions

These are the decision-making rights that are limited to how to operate the asset or how to maintain the asset.

The assessment on whether the customer has a right to direct the use of the identified asset relies on *who* takes the "how and for what purpose" decisions (i.e. the first level of decision-making rights). If such decisions (for example, deciding when the output is produced) are made by the customer (i.e. the lessee), the customer has the right to direct the use of the identified asset and the contract is a lease, providing that the other conditions are fulfilled. On the contrary, if such decisions are made by the supplier, the customer does *not* have the right to direct the use of the asset which leads to the conclusion that the contract does not contain a lease.

Although operating decisions are often essential to the efficient use of an asset, they are *not* rights to direct how and for what purpose the asset is used and are often dependent on the decisions about how and for what purpose the asset is used. Therefore in the above assessment, an entity does not need to consider rights to make operating decision (i.e. the second level of decision-making rights). In other words, the customer does not need the right to operate the asset to have the right to direct its use.

(Note: The above discussion is simplified. The "how and for what purpose" decisions may be predetermined. In such cases, further analysis is required. Yet, such situations are not within the scope of PBE Paper I and candidates taking this paper are not required to tackle such situations.)

In a contract, there may be terms and conditions providing "protective rights". Protective rights define the scope of the customer's right of use and are designed to:

- Protect the supplier's interest in the asset

- Protect the supplier's personnel

- Ensure the supplier's compliance with laws or regulations

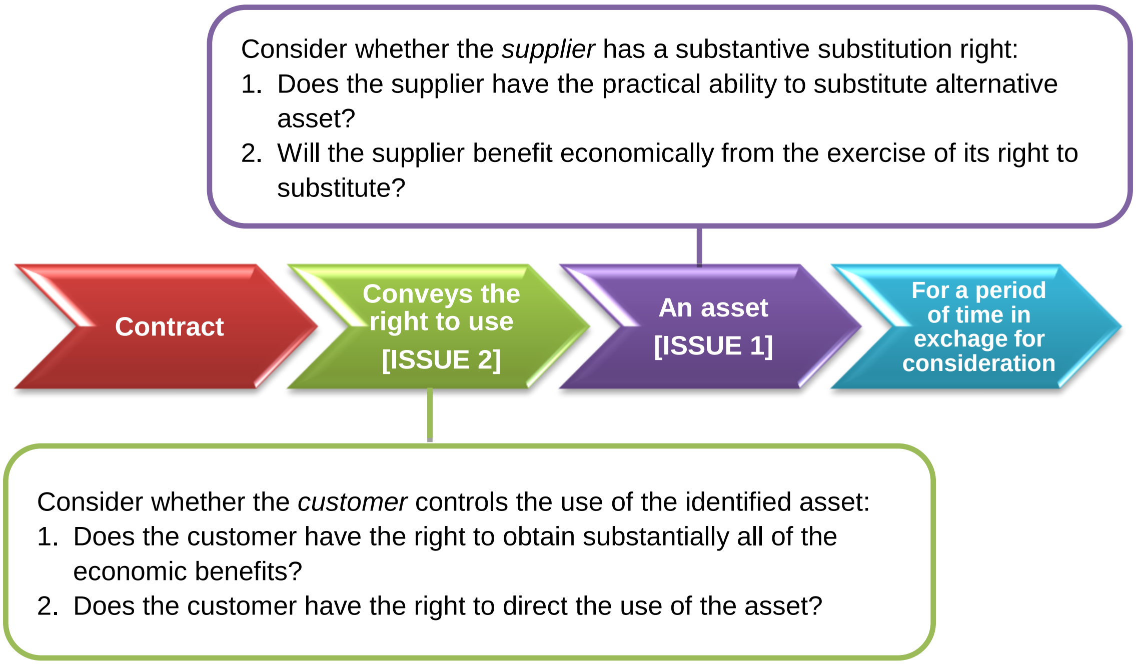
Protective rights do *not* prevent the customer from having the right to direct the use of an asset.

To summarise, there are three types of rights:

Decision-making rights	Descriptions	In determining whether the customer has a right to direct the use of the identified asset?
1. "How and for what purpose" decisions	The decision-making rights that are most relevant to changing how and for what purpose the asset is used	Relevant • If decisions are taken by the customer, the customer has the right to direct the use of the identified asset • If decisions are taken by the supplier, the customer does not have the right to direct the use of the identified asset
2. Operating decisions	Operating the asset or maintaining the asset	Irrelevant *(in PBE Paper I)*
3. Protective rights	Define the scope of the customer's right to use an asset	Irrelevant

1.3 A comprehensive analysis for the identification of a lease

The following diagram recaps the important concepts when identifying a lease contract:



2. LESSEE ACCOUNTING: BASIC CONCEPTS

It is important to understand clearly the following concepts before going through the accounting treatments of a lease from the lessee's perspective.

2.1 Lease term

> ***Definition***
>
> ***Commencement date***
>
> *The date on which a lessor makes an underlying asset available for use by a lessee.*

The lease term is the non-cancellable period of a lease, together with both:

- Periods covered by an option to extend the lease (i.e. optional renewal periods) if the lessee is reasonably certain to *exercise* that option; and
- Periods covered by an option to terminate the lease (i.e. periods after an optional termination date) if the lessee is reasonably certain *not* to *exercise* that option.

The lease term starts at the commencement date and includes rent-free periods covered in the contract.

Example 1 – Determining the lease term

Lessee Ltd. and Lessor Ltd. enters into a lease for a vehicle that includes a non-cancellable term of three years and a one-year renewal option with future lease payments approximating market rates. It is assessed that Lessee Ltd. is *not* reasonably certain to exercise the renewal option.

At the commencement date, the lease term between Lessee Ltd. and Lessor Ltd. is determined to be three years.

On the contrary, if it is assessed that Lessee Ltd. is reasonably certain to exercise the renewal option, for example, the exercise price of the renewal option is low, the lease term between Lessee Ltd. and Lessor Ltd. is determined to be four years at the commencement date.

2.2 Lease payments

Definitions

Lease payments (for a lessee)

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

- *Fixed payments, less any lease incentives (receivable from the lessor);*
- *Variable lease payments that depend on an index or a rate;*
- *Exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and*
- *Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

Lease payments also include amounts expected to be payable by the lessee under residual value guarantees.

Residual value guarantees

A guarantee made to a lessor by a party unrelated to the lessor that the value of an underlying asset at the end of a lease will be at least a specified amount.

2.2.1 Lease incentives

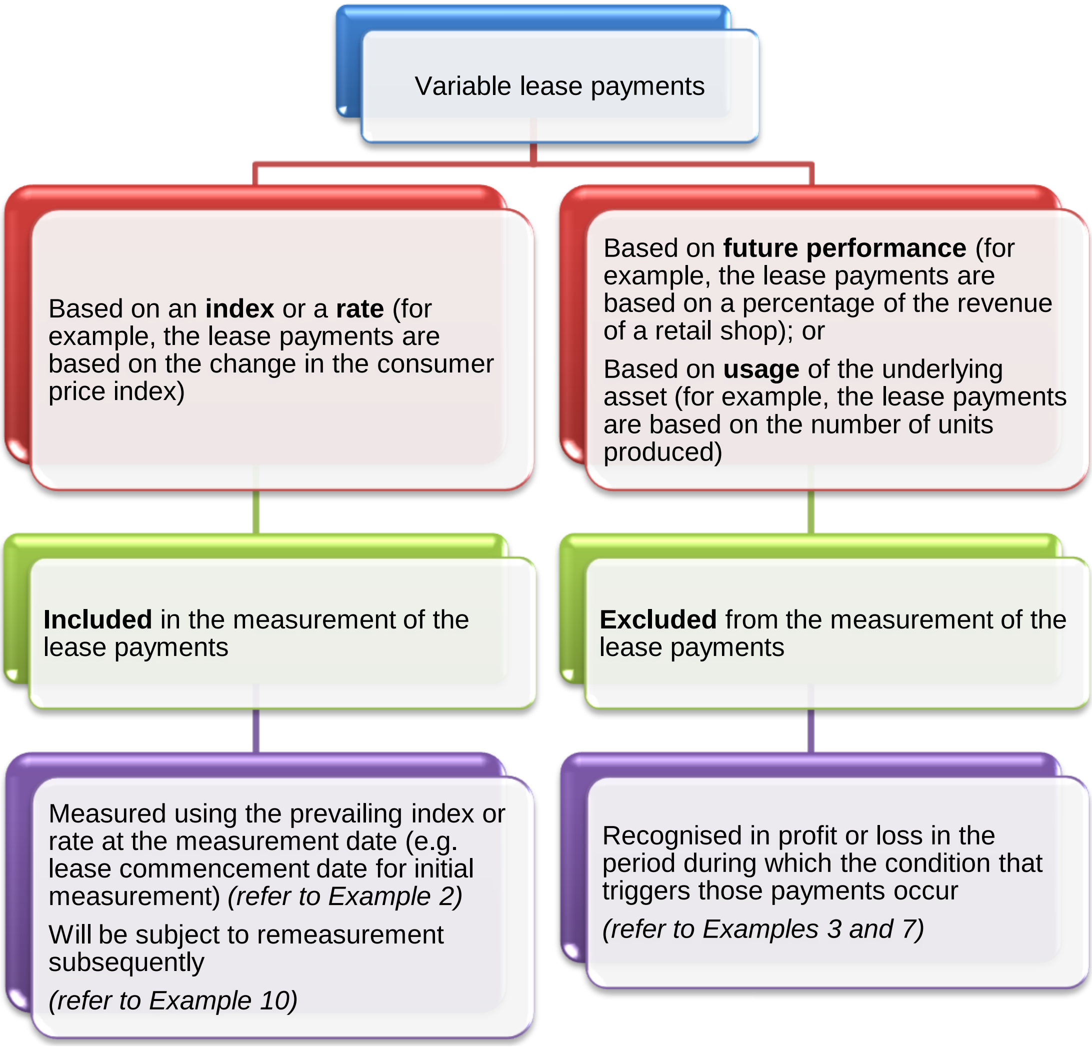
Lease incentives refer to:

- those payments made by a lessor to a lessee associated with a lease; or
- the reimbursement by a lessor of costs of a lessee; or
- the assumption by a lessor of costs of a lessee.

Common examples include an up-front cash payment to the lessee and payment of moving costs for the lessee. These amounts are deducted from the lease payments.

2.2.2 Variable lease payments

Lease payments may be variable because of changes in circumstances after the commencement date. Broadly speaking, from the perspective of HKFRS 16, variable lease payments can be divided into two types:



Example 2 – Variable lease payments based on an **index** or a **rate**

On 1 January 20X8, Lessee Ltd. entered into a three-year contract to lease a studio in Kwun Tong. The initial annual rental payment was HK$600,000. The rent would be reviewed every year and increased by the change in the consumer price index ("CPI").

The lease payments were variable and the amount was based on an index. Such variable lease payments were included in the measurement of the lease payment on 1 January 20X8. The initial measurement of the lease payment would be based on the value of the CPI on the lease commencement date. In other words, Lessee Ltd. assumed an annual rental of HK$600,000 for the three years and included HK$1,800,000 (HK$600,000 x 3) in the measurement of the lease payments at the commencement of the lease. The subsequent measurement relating to this lease will be illustrated in Example 10.

Example 3 – Variable lease payments based on **future performance** (initial measurement)

On 1 January 20X8, Lessee Ltd. entered into a two-year contract to lease a retail store in Kwai Chung. It was agreed that the lease payment for the store would amount to two per cent of the store's revenues.

The lease payments were variable and the amount was neither based on an index nor a rate. Such variable lease payments were not included in the measurement of the lease payment. In other words, Lessee Ltd. included zero amount in the measurement of the lease payments at the commencement of the lease. The subsequent measurement relating to this lease will be illustrated in Example 7.

2.2.3 Amounts expected to be payable under residual value guarantees

Sometimes, a lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. This guarantee forms an obligation that the lessee has assumed by entering into the lease.

From the lessee's perspective, lease payments include the amounts expected to be payable to the lessor under residual value guarantees that it provides to the lessor.

Example 4 - Lease payment includes residual value guarantees provided by lessee

On 1 January 20X6, Lessee Ltd. entered into a lease of a machine, Model X, with Lessor Ltd. for three years. Lessee Ltd. and Lessor Ltd. agreed that, if the fair value of Model X at the end of the lease term (i.e. 31 December 20X8) was below HK$45,000, Lessee Ltd. would pay to Lessor Ltd. an amount equal to the difference between HK$45,000 and the fair value of Model X. On 1 January 20X8, Lessee Ltd. expected that the fair value of Model X at 31 December 20X8 would be:

(i) HK$48,000;
(ii) HK$45,000;
(iii) HK$39,000.

The potential payment should the fair value of Model X at 31 December 20X8 fall below HK$45,000 was an example of residual value guarantees. In situations (i) and (ii), there would be no payment expected to be payable to Lessor Ltd. Lessee Ltd. therefore included zero amount in the lease payments regarding the residual value guarantees.

In situation (iii), it was expected that Lessee Ltd. would need to pay to Lessor Ltd. HK$6,000 (HK$45,000 – HK$39,000) under the residual value guarantees. Lessee Ltd. therefore included HK$6,000 in the lease payments regarding the residual value guarantees. It should be noted *not* the *full amount* of the residual value guarantees (i.e. HK$45,000) would be included in the lease payments for a lessee. This will be contrasted against the situation in Example 12 in Section 8 regarding the measurement of lease payment from a lessor's perspective.

2.3 Discount rates

Definitions

Interest rate implicit in the lease

The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

Unguaranteed residual value

That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial direct costs

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.

Lessee's incremental borrowing rate

The rate of interest that a lessee would have to pay to borrow the funds necessary to:

- *obtain an asset of a similar value to the identified asset;*
- *over a similar term (i.e. consistent with the lease term);*
- *with a similar security (for example, with similar collateral);*
- *in a similar economic environment.*

As payments relating to a lease contract are paid in the future, discount rates are crucial in measuring the transaction amount. In applying the relevant discount rate, to a lessee, it can be:

- the interest rate implicit in the lease; or
- the lessee's incremental borrowing rate, if the interest rate implicit in the lease cannot be readily determinable.

2.3.1 Interest rate implicit in the lease

It can be easier to visualise what the interest rate implicit in the lease (represented by *r*) is by referring to the following equation:

$$\frac{Lease\ payment_1}{(1+r)^1} + \frac{Lease\ payment_2}{(1+r)^2} + \cdots + \frac{Lease\ payment_n}{(1+r)^n} + \frac{\begin{matrix} Unguaranteed \\ residual\ value \end{matrix}}{(1+r)^n}$$

$$= Fair\ value + Initial\ direct\ costs_{Lessor}$$

In the above equation, the lease payments refer to those amounts discussed in Section 2.2 *Lease payments* and are assumed to be paid at the end of each period.

In simple terms, residual value of an identified asset refers to the estimated amount that the lessor would realise from, say disposal, at the end of the lease term. Such residual value can be guaranteed or unguaranteed. The unguaranteed residual value simply refers to the part that is not guaranteed.

2.3.2 Initial direct costs

Examples of initial direct costs incurred by the lessor include:

- commissions;
- payments made to existing tenants to incentivise those tenants to terminate their leases; and
- legal fees and costs of negotiating the lease terms, if these are contingent on the origination of the lease

HKFRS 16 however excludes allocated costs (for example, salaries) and costs that are incurred regardless whether the lease is obtained (for example, legal advices) as initial direct costs.

Although HKFRS 16 suggests that the ideal discount rate for a lessee to discount the lease payment should be the interest rate implicit in the lease, it is very likely that the lessee will use their own incremental borrowing rate for computations. This is because the lessee will only have limited information about the expected residual value of the underlying asset at the end of the lease term (therefore not able to estimate the unguaranteed residual value) as well as the initial direct costs incurred by the lessor.

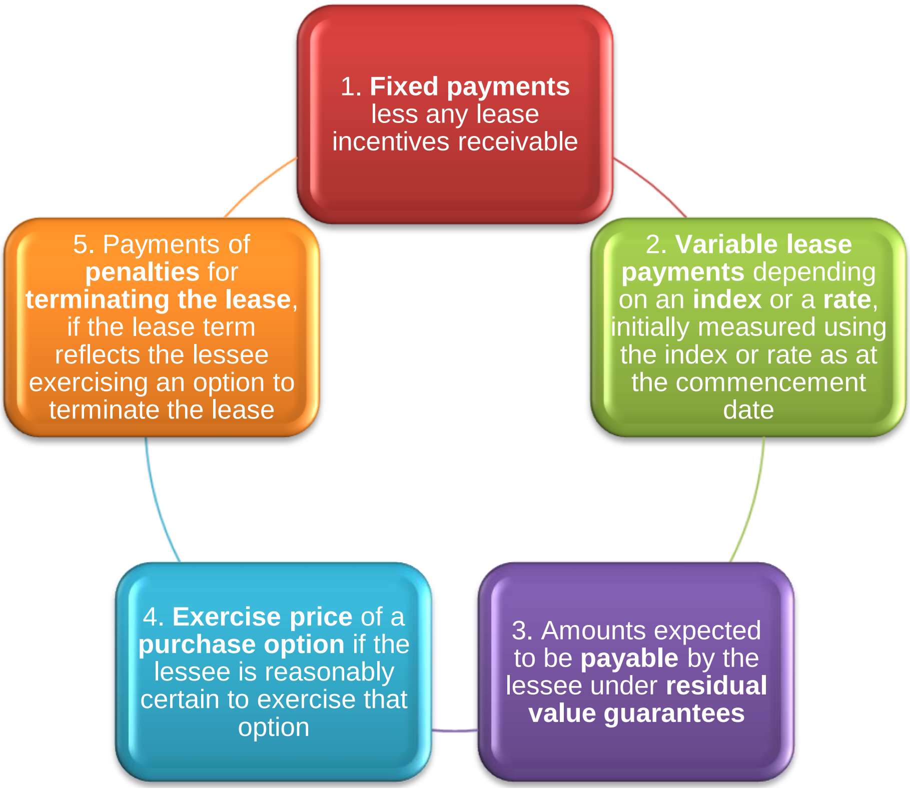
Candidates are advised to refer to PBE Paper I Official Study Text (2nd Edition) Chapter 7 Example 4 (page 124) for further illustration.

3. LESSEE ACCOUNTING: INITIAL AND SUBSEQUENT MEASUREMENT

HKFRS 16 requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date.

3.1 Lease liability: Initial measurement

At the commencement date, a lessee measures the lease liability at the present value of the lease payments (refer to Section 2.2 *Lease payments*) that are *not paid* at that date. In discounting such lease payments, the discount rate will be the interest rate implicit in the lease or the lessee's incremental borrowing rate if the interest rate implicit in the lease cannot be readily determinable (refer to Section 2.3 *Discount rates*). The following diagram recaps the five elements of lease payments included in the initial measurement of the lease liability:



3.2 Right-of-use asset: Initial measurement

At the commencement date, a lessee measures the right-of-use asset at cost. The cost of the right-of-use asset starts with the amount of the initial measurement of the lease liability and make further adjustments. Such cost includes:

(i) The amount of the initial measurement of the lease liability (refer to Section 3.1 *Lease liability: Initial measurement*);

(ii) Any lease payments made at or before the commencement date,

(iii) Any initial direct costs incurred by the lessee;

(iv) An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms of the lease (Note: This is similar to the requirements in HKAS 16 *Property, Plant and Equipment*. Refer to PBE Paper I Official Text Chapter 5. Such liability is recognised and measured in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.)

(v) Less any lease incentives already received.

Example 5 – Lessee's initial measurement of lease liability and right-of-use asset

On 1 January 20X3, Lessee Ltd. entered into a contract with Lessor Ltd. to lease a machine for five years. The annual lease payments were HK$30,000, payable at the end of each year. The interest rate implicit in the lease was not readily determinable and the incremental borrowing rate of Lessee Ltd. was 4.5 per cent. Lessee Ltd. did not incur any initial direct cost associated with this lease.

In this lease contract between Lessee Ltd. and Lessor Ltd., the only lease payments involved fixed payments payable at the end of each year. As the interest rate implicit in the lease was not readily determinable, the rate used to discount the lease payments would then be Lessee Ltd.'s incremental borrowing rate (i.e. 4.5%). The initial measurement of the lease liability could be computed using the following schedule:

Payment date	Lease payment (HK$)		Discount factor		Present value (HK$)
31 December 20X3	30,000	÷	$(1 + 4.5\%)^1$	=	28,708
31 December 20X4	30,000	÷	$(1 + 4.5\%)^2$	=	27,472
31 December 20X5	30,000	÷	$(1 + 4.5\%)^3$	=	26,289
31 December 20X6	30,000	÷	$(1 + 4.5\%)^4$	=	25,157
31 December 20X7	30,000	÷	$(1 + 4.5\%)^5$	=	24,074
	Lease liability at commencement date				131,700

The lease liability recognised by Lessee Ltd., on 1 January 20X3, was then HK$131,700. The right-of-use asset recognised by Lessee Ltd. at the commencement date was the same (without any further adjustment). The pair of journal entries made by Lessee Ltd. on 1 January 20X3 was:

Dr. Right-of-use asset	131,700	
Cr. Lease liability		131,700

To initially recognise the right-of-use asset and lease liability

Assume Lessee Ltd. incurred and paid HK$3,000 as initial direct cost associated with this lease. The lease liability recognsied was still HK$131,700. Yet, the right-of-use asset included the initial measurement of the lease liability (HK$131,700) and the initial direct cost incurred (HK$3,000). The right-of-use asset amounted to HK$134,700. The pair of journal entries made by Lessee Ltd. on 1 January 20X3, under this revised scenario, was:

Dr. Right-of-use asset	134,700	
Cr. Lease liability		131,700
Cr. Cash		3,000

To initially recognise the right-of-use asset and lease liability together with the payment of initial direct costs

It shows a difference in the amounts recognised for the right-of-use asset and the lease obligation in the above illustration. HKFRS 16 requires the right-of-use asset to be measured initially at cost. This approach is consistent with the measurement of many other non-financial assets such as property, plant and equipment and intangible asset. Specifically, including the initial direct costs in the initial measurement of right-of-use asset is similar to the inclusion of directly attributable costs* in the initial measurement of a property, plant and equipment item under HKAS 16. The lease liability however refers to a present *obligation* to make lease payments once the underlying asset has been made available to the lessee. Such obligation will only take into consideration the *unpaid* contractual cash payments causing an outflow of economic benefits in the *future*. This explains the difference in the amounts recognised for the two items.

** Directly attributable costs are the costs directly attributable to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management.*

Assume further that Lessee Ltd. incurred and paid HK$3,000 as initial direct cost associated with this lease while Lessor Ltd. reimbursed immediately HK$2,000 of the initial direct cost incurred by Lessee Ltd. The lease liability recognsied was still HK$131,700. Yet, the reimbursement of the initial direct cost was considered as lease incentives which reduced the amount of the right-of-use asset. The right-of-use asset, in this scenario, amounted to HK$132,700. (HK$134,700 – HK$2,000).

3.3 Lease liability: Subsequent measurement

After the commencement date, a lessee measures the lease liability by:

- Increasing the carrying amount to reflect interest on the lease liability;
- Reducing the carrying amount to reflect the lease payments made;
- Remeasuring the carrying amount to reflect reassessment (if any).

3.3.1 The effective interest method

The interest on the lease liability in each period during the lease term is the amount that produces a constant periodic rate of interest (i.e. the discount rate) on the remaining balance of the lease liability. This is similar to the effective interest method discussed in PBE Paper I Official Study Text (2nd Edition) Chapter 9 *Financial Instruments*. Such interest expense is recognised in profit or loss.

Example 6 – Lessee's subsequent measurement of lease liability

Following the original facts in Example 5. The lease liability would be measured subsequently as follow:

Date	Payment (HK$)	Interest expense in profit or loss (HK$)	Reduction in the balance (HK$)	Carrying amount (HK$)
1 January 20X3				131,700
31 December 20X3	30,000	131,700 x 4.5% = 5,927	30,000 – 5,927 = 24,073	131,700 – 24,073 = 107,627
31 December 20X4	30,000	107,627 x 4.5% = 4,843	30,000 – 4,843 = 25,157	107,627 – 25,157 = 82,470
31 December 20X5	30,000	82,470 x 4.5% = 3,711	30,000 – 3,711 = 26,289	82,470 – 26,289 = 56,181
31 December 20X6	30,000	56,181 x 4.5% = 2,528	30,000 – 2,528 = 27,472	56,181 – 27,472 = 28,709
31 December 20X7	30,000	28,709 x 4.5% = 1,292	28,709* (rounded)	0* (rounded)

On 31 December 20X3, Lessee Ltd. paid HK$30,000 for its first lease payment. Out of this HK$30,000, HK$5,927 related to the interest on the lease liability (HK$131,700 x 4.5%) while the remaining portion HK$24,073 (HK$30,000 – HK$5,927) reduced the lease liability balance.

On 31 December 20X3, Lessee Ltd. prepared the following pairs of journal entries in relation to lease liability:

Dr. Interest expense (P/L)	5,927	
Cr. Lease liability		5,927

To recognise the interest expense associated with the lease during the first year accompanied by an increase in the lease liability

Dr. Lease liability	30,000	
Cr. Cash		30,000

To recognise the first lease payment with a reduction in the lease liability

Note: This example continues in Example 8 in Section 3.4.1 Depreciation regarding the depreciation of the right-of-use asset.

3.3.2 Remeasurement of the lease liability

Remeasurement of the lease liability is required under a number of circumstances, such as:

- Change in the lease term *(out of scope of PBE Paper I)*;
- Change in the amounts expected to be payable under a residual value guarantee *(out of scope of PBE Paper I)*;
- Change in the future lease payments resulting from a change in an index or a rate used to determine those payments *(within the scope of PBE Paper I)*.

The last situation relates to variable lease payments discussed in Section 2.2.2 *Variable lease payments*. If there is a change in the cash flows for future payments resulting from a change in index or rate used to determine the lease payments, the lessee is required to remeasure the lease liability. For this remeasurement, the lessee:

- Determines the revised lease payments for the remaining lease term based on the revised contractual payments; and
- Discounts such revised lease payments with an *unchanged* discount rate.

It should be noted that, for variable lease payments not included in the measurement of the lease liability (for example, lease payments based on percentage of revenue generated), the amounts are recognised in profit or loss in the period in which the condition that triggers those payments occur. Such subsequent payments will not trigger any remeasurement of the lease liability as it was not initially included as part of the lease liability.

Example 7 – Variable lease payments based on future performance

Following the facts in Example 3. During the year ended 31 December 20X8, the retail store earned an annual revenue of HK$20,000,000.

Lessee Ltd. was required to pay HK$400,000 (HK$20,000,000 x 2%) to the lessor. This payment did not relate to the lease liability. Instead, the lease payment was recognised in profit or loss during the year ended 31 December 20X8. Lessee Ltd. prepared the following pair of journal entries during the year:

Dr. Rental expense	400,000	
Cr. Cash		400,000

To recognise the lease payment based on performance in profit or loss

3.4 Right-of-use asset: Subsequent measurement

After commencement date, a lessee measures the right-of-use asset applying a cost model. In other words, the right-of-use asset is carried at:

- Cost;
- Less accumulated depreciation;
- Less accumulated impairment losses; and

- Adjusted for any remeasurement of the lease liability (related to Section 3.3.2 *Remeasurement*)

3.4.1 Depreciation

HKFRS 16 requires a lessee to apply the depreciation adjustments in HKAS 16 in depreciating the right-of-use asset. In other words, the depreciation method should reflect the pattern in which the future economic benefits of the right-of-use asset are consumed. This will usually result in a straight-line depreciation charge in profit or loss.

Depreciation starts at the commencement date of the lease. The problematic issue is to determine the period over which the right-of-use asset is depreciated, which follows the rules below:

Scenario		Depreciate till
1	Lease term > useful life	The end of the useful life
2	Lease term < useful life	The end of the lease term
3	Reasonably certain for the lessee to exercise a purchase option	The end of the useful life
4	Ownership of the underlying asset transferred to lessee by the end of the lease term	The end of the useful life

Example 8 – Lessee's subsequent measurement of right-of-use asset (1)

Following the original facts in Example 5. During the year ended 31 December 20X3, Lessee Ltd. recognised depreciation expense amounting to HK$26,340 (HK$131,700 ÷ 5 years) in profit or loss. During the year ended 31 December 20X3, Lessee Ltd. prepared the following pair of journal entries:

Dr. Depreciation expense	26,340	
Cr. Accumulated depreciation: ROU		26,340

To recognise the annual depreciation expense associated with the right-of-use (ROU) asset in profit or loss

Example 9 – Lessee's subsequent measurement of right-of-use asset (2)

On 1 January 20X7, Lessee Ltd. entered into a non-cancellable, non-renewable three-year contract with Lessor Ltd. to lease a machine, Model Y. On 1 January 20X7, the useful life of Model Y was assessed to be five years. The terms of the contract did not transfer the ownership of Model Y by the end of the lease term. On 1 January 20X7, Lessee Ltd. recognised a right-of-use asset amounting to HK$450,000 arising from this lease transaction.

As the lease term was shorter than the useful life of the identified asset (i.e. Model Y), Lessee Ltd. depreciated the right-of-use asset associated with Model Y starting from 1 January 20X7 over the lease term of three years at an annual rate of HK$150,000 (HK$450,000 ÷ 3 years).

3.4.2 Impairment

A lessee applies HKAS 36 *Impairment of Assets* to determine whether a right-of-use asset is impaired and to account for any impairment. The process is summarised below:

(i) Analyse whether there is any impairment indicator at each reporting period;

(ii) Estimate the recoverable amount of the asset if any impairment indicator is present;

(iii) Recognise an impairment loss in profit or loss if the recoverable amount of the asset is less than the carrying amount of the asset;

(iv) Calculate depreciation expense thereafter using the adjusted carrying amount as basis.

One of the events triggering the impairment review is that the lessee, for example, due to relocation does not occupy the premise which is under a non-cancellable lease. The property is then left vacant and the lease cannot generate any economic benefits in the remaining years. The right-of-use asset should therefore be impaired. This replaces the discussion of onerous contract arising from an operating lease discussed in PBE Paper I Official Study Text (2^{nd} Edition) Chapter 8 *Provisions, Contingent Liabilities and Contingent Assets* (page 144).

3.4.3 Remeasurement

The remeasurement of the lease liability discussed in Section 3.3.2 *Remeasurement* will trigger an adjustment to the carrying amount of the right-of-use asset, unless the carrying amount of the right-of-use asset has already been reduced to zero. In such case, further reductions are recognised in profit or loss.

Example 10 - Variable lease payments based on an index

On 1 January 20X4, Lessee Ltd. entered into a non-cancellable four-year contract with Lessor Ltd. to lease a machine, Model Z. The lease payments were set initially at HK$33,000 and would be paid by Lessee Ltd. on every 31 December. The interest rate implicit in the lease was not readily determinable. Lessee Ltd.'s incremental borrowing rate was determined to be five per cent. It was negotiated that the lease payments for each year would increase on the basis of the increase in the Consumer Price Index ("CPI") for the preceding year. On 1 January 20X4, the CPI was 110. On 31 December 20X4, the CPI increased to 115 which remained unchanged throughout the year ended 20X5.

Initial measurement

HKFRS 16 requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date. At the commencement date, a lessee measures:

(i) the lease liability at the present value of the lease payments that are *not paid* at that date. In discounting such lease payments, the discount rate will be the interest rate implicit in the lease or the lessee’s incremental borrowing rate if the interest rate implicit in the lease cannot be readily determinable; and

(ii) the right-of-use asset at cost. The cost of the right-of-use asset starts with the amount of the initial measurement of the lease liability, with further adjustments if necessary.

In this case, the lease contract between Lessee Ltd. and Lessor Ltd. involved variable lease payments based on an index (i.e. the CPI). Such lease payments were:

- included in the measurement of the lease liability;
- measured using the prevailing index or rate at the commencement date;
- discounted at Lessee Ltd.'s incremental borrowing rate.

The initial measurement of the lease liability could be computed using the following schedule:

Payment date	Lease payment (HK$)		Discount factor		Present value (HK$)
31 December 20X4	33,000	÷	$(1 + 5\%)^1$	=	31,429
31 December 20X5	33,000	÷	$(1 + 5\%)^2$	=	29,932
31 December 20X6	33,000	÷	$(1 + 5\%)^3$	=	28,507
31 December 20X7	33,000	÷	$(1 + 5\%)^4$	=	27,149
	Lease liability at commencement date				117,017

The lease liability recognised by Lessee Ltd., on 1 January 20X4, was then HK$117,017. The right-of-use asset recognised by Lessee Ltd. at the commencement date was the same (without any further adjustment). The pair of journal entries made by Lessee Ltd. on 1 January 20X4 was:

Dr. Right-of-use asset	117,017	
Cr. Lease liability		117,017

To initially recognise the right-of-use asset and lease liability

Subsequent measurement: Year 1

(i) the lease liability using the effective interest method; and

(ii) the right-of-use asset at its cost less accumulated depreciation.

At 31 December 20X4, the lease liability was measured subsequently as follow:

Date	Payment (HK$)	Interest expense in profit or loss (HK$)	Reduction in the balance (HK$)	Carrying amount (HK$)
1 January 20X4				117,017
31 December 20X4	33,000	117,017 x 5% = 5,851	33,000 – 5,851 = 27,149	117,017 – 27,149 = 89,868

On 31 December 20X4, Lessee Ltd. paid HK$33,000 for its first lease payment. Out of this HK$33,000, HK$5,851 related to the interest on the lease liability (HK$117,017 x 5%) while the remaining portion HK$27,149 (HK$33,000 – HK$5,851) reduced the lease liability balance.

On 31 December 20X4, the right-of-use asset has been depreciated over the lease term (four years) at an annual charge of HK$29,254 (HK$117,017 ÷ 4 years) in profit or loss.

On 31 December 20X4, Lessee Ltd. prepared the following pairs of journal entries:

Dr. Interest expense (P/L)	5,851	
Cr. Lease liability		5,851

To recognise the interest expense associated with the lease during the first year accompanied by an increase in the lease liability

Dr. Lease liability	33,000	
Cr. Cash		33,000

To recognise the first lease payment with a reduction in the lease liability

Dr. Depreciation expense	29,254	
Cr. Accumulated depreciation: ROU		29,254

To recognise the annual depreciation expense for the first year associated with the right-of-use (ROU) asset in profit or loss

HKFRS 16 requires that if there is a change in the cash flows for future payments resulting from a change in index or rate used to determine the lease payments, the lessee is then required to remeasure the lease liability. For this remeasurement, the lessee first determines the revised lease payments for the remaining lease term based on the revised contractual payments and discounts such revised lease payments with an unchanged discount rate.

In this case, the CPI increased from 110 to 115. There would be an increase in the cash flows for future payments. The lease liability (together with the right-of-use asset) would be remeasured. The revised payments for the subsequent years, starting from the second year would be HK$34,500 (HK$33,000 x 115 ÷ 110). The adjustment was the difference between:

- the original lease payments (HK$33,000); and
- the revised lease payments (HK$34,500), discounted over the remaining three years at the original discount rate of 5%:

Payment date	*Extra* lease payment (HK$)		Discount factor		Present value (HK$)
31 December 20X5	1,500*	÷	$(1 + 5\%)^1$	=	1,429
31 December 20X6	1,500	÷	$(1 + 5\%)^2$	=	1,361
31 December 20X7	1,500	÷	$(1 + 5\%)^3$	=	1,296
			Total		4,086

(Note: HK$34,500 – HK$33,000)*

On 31 December 20X4, Lessee Ltd. prepared the following pair of journal entries:

Dr. Right-of-use asset (ROU)	4,086	
Cr. Lease liability		4,086

To remeasure the lease liability and the right-of-use asset due to a change in the CPI

After the remeasurement, the balances of the lease liability and the right-of-use asset as at 31 December 20X4 were HK$93,954 (HK$89,868 + HK$4,086) and HK$91,849 (HK$117,017 – HK$29,254 + HK$4,086) respectively.

Subsequent measurement: Year 2

At 31 December 20X5, the lease liability was measured subsequently as follow:

Date	Payment (HK$)	Interest expense in profit or loss (HK$)	Reduction in the balance (HK$)	Carrying amount (HK$)
1 January 20X4				117,017
31 December 20X4	33,000	5,851	27,149	89,868
Remeasurement				4,086
Adjusted carrying amount				93,954
31 December 20X5	34,500	93,954 x 5% = 4,698	34,500 – 4,698 = 29,802	93,954 – 29,802 = 64,152

On 31 December 20X5, the right-of-use asset has been depreciated over the remaining three years at an annual charge of HK$30,616 (HK$91,849 ÷ 3 years) in profit or loss.

On 31 December 20X5, Lessee Ltd. prepared the following pairs of journal entries:

Dr. Interest expense (P/L)	4,698	
Cr. Lease liability		4,698

To recognise the interest expense associated with the lease during the second year accompanied by an increase in the lease liability

Dr. Lease liability	34,500	
Cr. Cash		34,500

To recognise the second lease payment with a reduction in the lease liability

Dr. Depreciation expense	30,616	
Cr. Accumulated depreciation: ROU		30,616

To recognise the annual depreciation expense for the second year associated with the right-of-use asset in profit or loss

4. LESSEE ACCOUNTING: RECOGNITION EXEMPTION

HKFRS 16 provides practical expedient to the above lessee accounting (i.e. not to recognise a lease liability and a right-of-use asset at lease commencement), under the following two circumstances:

(i) Short-term leases

Short-term leases are those leases, at commencement date, has a lease term of 12 months or less.

(ii) Leases of low-value assets

Low-value assets are those assets, when new, have a value of US$5,000 or less. Examples are laptop computers, tablets and telephones.

If a lessee elects not to apply the lessee accounting requirements in Section 3 to either short-term leases or leases for which the underlying asset is of low value, the lessee recognises the lease payment as an expense on a straight-line basis over the lease term (or another systematic basis that is more representative of the pattern of the lessee's benefit).

Example 11 – Recognition exemption

On 1 January 20X7, Lessee Ltd. entered into a non-cancellable 15-month contract with Lessor Ltd. for a portable printer, Model P2. Lessee Ltd. was required to pay HK$2,000 at the end of each month. On 1 January 20X7, Model P2, under the existing condition, had a value of HK$32,000. On the same date, a new Model P2 had a value of HK$45,000.

The recognition exemption applies to low-value assets having a value of US$5,000 when new. The current market price of the underlying asset is not relevant in applying the practical expedient. Further, the lease of Model P2 had a lease term of more than 12 months. Lessee Ltd. could not apply the practical expedient not to recognise the lease liability and the right-of-use asset for the lease associated with Model P2.

If a new Model P2 had a value of HK$30,000, Lessee Ltd. could then elect not to recognise the lease liability and the right-of-use for this lease. In such case, Lessee Ltd. prepared the following journal entry at the end of each month:

Dr. Rent expense	2,000	
Cr. Cash		2,000

To recognise the monthly rental payment for renting Model P2 with an application of the practical expedient

It should be noted that the practical expedient to the above two types of leases have slight difference:

(i) The election not to recognise the lease liability and the right-of-use asset for short-term leases is made by ***class*** of underlying asset to which the right-of-use asset relates. In other words, if a lessee chooses not to apply the lessee accounting model detailed in Section 3 for short-term machinery leasing, all future short-term leases for machinery items have to be accounted for in the same way.

(ii) The election not to recognsie the lease liability and the right-of-use asset for leases of low-value assets is made on a ***lease-by-lease*** *basis*. In other words, a lessor can choose to apply the lessee accounting model detailed in Section 3 for Laptop X and apply the practical expedient for Laptop Y, assuming Laptops X and Y are under two separate leases and have values, when new, below US$5,000.

5. LESSEE ACCOUNTING: PRESENTATION AND DISCLOSURE

5.1 Presentation

5.1.1 Statement of financial position

Right-of-use assets are presented either:

- Separately from other asset (e.g. owned assets); or
- Together with other assets as if they were owned with disclosures in the notes to the financial statements.

Lease liability is presented either:

- Separately from other liabilities; or
- Together with other liabilities, with disclosures in the notes to the financial statements.

5.1.2 Statement of profit or loss and other comprehensive income

Lease-related depreciation and lease-related interest expense are presented separately. These items cannot be combined. Interest expense on the lease liability is a component of finance costs.

5.1.3 Statement of cash flows

Cash payments for the principal portion of the lease liability (for example, HK$24,073 in Example 6) are presented within financing activities.

Cash payments for the interest portion of the lease liability (for example, HK$5,927 in Example 6) are presented based on the accounting policy election in accordance with HKAS 7 *Statement of Cash Flows* (i.e. either within operating activities or financing activities.)

5.2 Disclosures

A lessee is required to disclose the following:

- Depreciation charge for right-of-use assets by class of underlying asset;
- Interest expense on lease liabilities;
- The expense relating to short-term leases and leases of low-value assets accounted for applying the recognition exemption;
- The expense relating to variable lease payments not included in the measurement of lease liabilities;

- Total cash outflow for leases;
- Additions of right-of-use assets;
- The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

6. LESSOR ACCOUNTING: BASIC CONCEPTS

Most of the basic concepts discussed in Section 2 *Lessee accounting: Basic concepts* are applicable here. Yet, there are a few distinctions in those concepts between lessee and lessor.

6.1 Lease payments

Definition

Lease payments (for a lessor)

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

- *Fixed payments, less any lease incentives that are paid or payable to the lessee;*
- *Variable lease payments that depend on an index or a rate;*
- *Exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and*
- *Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

Lease payments also include residual value guarantees provided to the lessor by:

- *The lessee;*
- *A party related to the lessee; or*
- *A party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee (for example, bank).*

The first four elements in the above definition are the same for both the lessee and lessor. Yet, for the element relating to the residual value guarantees, two important points should be highlighted:

(i) For a lessee, only the amounts expected to be payable by the lessee under residual value guarantees is included in the lease payment. It does not represent the maximum exposure under the residual value guarantees. Candidates are advised to refresh their understanding of this learning point by referring to Example 4 Case (iii). For a lessor, however, it includes the full amount of the residual value guarantees.

(ii) For a lessee, it includes only the amounts expected to be payable by the lessee to the lessor. For a lessor, the amount represents the residual value guaranteed not only by the lessee, but also third party other than the lessee.

6.2 Discount rate

A lessor should always use the interest rate implicit in the lease as the discount rate. The incremental borrowing rate is irrelevant.

7. LESSOR ACCOUNTING: CLASSIFICATION OF LEASES

A lessor, in accordance with HKFRS 16, classifies each of its leases as either an operating lease or a finance lease at lease inception. This classification is unique to the lessor and is not applicable to the lessee.

Definitions

Finance lease

A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease

A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

The classification test is substantially the same as the previous accounting standard HKAS 17 *Leases*. Candidates should therefore study the PBE Paper I Official Text Chapter 7 Section 1.3 *Classification of leases* (pages 120, 121 and Example 2 on page 122), with the following modifications:

- Replace HKAS 17 with HKFRS 16;
- Replace the definition of operating lease with the above definition;
- The term "minimum lease payments" does not exist in HKFRS 16; instead, it should be replaced by "lease payments".

8. LESSOR ACCOUNTING: FINANCE LEASES

The treatments for finance lease in the books of a lessor are substantially the same as the previous accounting standard HKAS 17 *Leases*. Candidates should therefore study the PBE Paper I Official Study Text (2nd Edition) Chapter 7 Section 3 *Accounting and disclosures for finance leases in books of lessor* (pages 128, 129 and 130, up to Example 10), with the following modifications:

- Replace HKAS 17 with HKFRS 16;
- The term "minimum lease payments" does not exist in HKFRS 16; instead, it should be replaced by "lease payments".
- Modify Example 8 (page 129) with the example below.

Example 12 – Lessor's gross investment of lease

Lessee Ltd. leased a property from Lessor Ltd. with a lease term of three years. The monthly rental payment was HK$10,000. The estimated residual value was HK$35,000, and the residual value guarantees provided by Lessee Ltd. and Blue Ltd., the parent of Lessee Ltd. were HK$10,000 and HK$7,000 respectively. In addition, Lessor Ltd. receives a guarantee of HK$3,000 from a property agent.

The gross investment of this lease, from Lessor Ltd.'s perspective, was determined as follow:

	HK$'000
Fixed lease payments (HK$10,000 x 36 months)	360
Residual value guarantees provided by the lessee	10
Residual value guarantees provided by a party related to the lessee (i.e. Blue Ltd.)	7
Residual value guarantees provided by a party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee (i.e. the property agent)	3
Lease payments (for the lessor)	380
Add: Unguaranteed residual value (HK$35,000 – HK$10,000 – HK$7,000 – HK$3,000)	15
Gross investment of the lease	395

As an extended discussion, from Lessee Ltd.'s perspective, the lease payments amount was not HK$380,000. The lease payments amount, in the books of the lessee, would simply be HK$360,000 as there was no expected payments payable by the lessee to the lessor under the residual value guarantees.

(Modified from PBE Paper I Official Study Text (2nd Edition), Example 8, page 129)

9. LESSOR ACCOUNTING: OPERATING LEASES

The treatments for operating lease in the books of a lessor are substantially the same as the previous accounting standard HKAS 17 *Leases*. Candidates should therefore study the PBE Paper I Official Study Text (2nd Edition) Chapter 7 Section 5 *Accounting and disclosures for operating leases in books of lessor* (pages 132 and 133, up to Example 12).

10. LESSOR ACCOUNTING: PRESENTATION AND DISCLOSURE

10.1 Presentation

A lessor presents assets held under a finance lease as lease receivable in its statement of financial position. A lessor presents underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

10.2 Disclosures

For finance lease, a lessor discloses the finance income on the net investment in the lease. For an operating lease, a lessor discloses the lease income. Further, a lessor discloses additional qualitative and quantitative information about its leasing activities such as the nature of the lessor's leasing activities and how the lessor manages the risk associated with any rights it retains in the underlying assets.

11. CHAPTER REVIEW

A lease is a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be an identified asset in a contract, the supplier should not have a substantive substitution right. To demonstrate that the customer controls the use of the identified asset, the customer should have the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.

HKFRS 16 adopts a single model for all leases in the books of lessee. At the commencement date, a lessee recognises a right-of-use asset and a lease liability. The lease liability is initially measured at the present value of the lease payments that are not paid at the date of lease commencement. It is subsequently measured using the effective interest method. The right-of-use asset is initially measured at cost, starting from the initial measurement of the lease liability with further adjustments, if applicable. The right-of-use asset is then subsequently measured at cost less accumulated depreciation and impairment.

HKFRS 16 requires a lessor to classify each of its leases as either an operating lease or a finance lease at lease inception based on the assessment whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset.

A lessor recognises assets held under a finance lease and presents them as a receivable at an amount equal to the net investment in the lease and derecognises the underlying asset at the lease commencement date. The receivable is subsequently measured using the effective interest method.

A lessor recognises lease payments from operating leases as income on a straight-line basis.

EXERCISES

Question 1

On 1 April 2017, Phantom Electronics Limited ("PEL") entered into a lease for plant with a lease term of five years. The fair value of the plant on 1 April 2017 was HK$1,840,000. In accordance with the lease contract, PEL had to pay HK$440,000 upon signing the contract and would pay the remaining four instalments of HK$440,000 every 31 March. The implicit interest rate in the lease was ten per cent. PEL estimated the economic life of the plant to be five years with no residual value. PEL has adopted HFKRS 16 *Leases* to account for its lease transactions.

Required:

(a) **Analyse the lease transaction and prepare the relevant journal entries, with supporting calculations, in the books of PEL during the year ended 31 March 2018. Narratives are not required. Present your answers to the nearest dollar.**

(b) **Describe the presentation of the lease liability in PEL's statement of financial position as at 31 March 2018 with reference to HKAS 1 (Revised) *Presentation of Financial Statements*.**

(Adapted from HKIAAT's PBE Paper I, June 2018, Question 3)

Question 2

On 1 April 2018, Lemon Ltd. entered into a non-cancellable three-year contract with Ginger Ltd. to lease a machine, Model IX. The lease payments were set initially at HK$480,000 and would be paid by Lemon Ltd. on every 31 March. The interest rate implicit in the lease was not readily determinable. Lemon Ltd.'s incremental borrowing rate was determined to be six per cent. It was negotiated that the lease payments for each year would increase on the basis of the increase in the Consumer Price Index ("CPI") for the preceding year. On 1 April 2018, the CPI was 120. On 31 March 2019, the CPI increased to 125. On 31 March 2020, the CPI remained at 125.

On 1 January 2019, Lemon Ltd. entered into a non-cancellable nine-month contract with Rose Ltd. to lease another machine, Model V. Lemon Ltd. would pay HK$50,000 on every last day of the month. Lemon Ltd. has adopted HFKRS 16 *Leases* to account for its lease transactions.

Required:

(a) **Regarding the lease of Model IX with Ginger Ltd., prepare the relevant journal entries, with supporting calculations, in the books of Lemon Ltd. on 1 April 2018.**

(b) **Regarding the lease of Model IX with Ginger Ltd., explain how the change in the Consumer Price Index affects the lease transaction on 31 March 2019. Prepare the relevant journal entries, with supporting calculations, in the books of Lemon Ltd. on 31 March 2019.**

(c) **Regarding the lease of Model IX with Ginger Ltd., prepare the relevant journal entries, with supporting calculations, in the books of Lemon Ltd. on 31 March 2020.**

(d) **Explain whether Lemon Ltd. can apply any recognition exemption regarding the lease of Model V with Rose Ltd. and briefly explain the accounting treatments if such exemption can be applied.**

ANSWERS

Question 1(a)

HKFRS 16 requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date.

At the commencement date, a lessee measures the lease liability at the present value of the lease payments that are not paid at that date. In discounting such lease payments, the discount rate will be the interest rate implicit in the lease or the lessee's incremental borrowing rate if the interest rate implicit in the lease cannot be readily determinable.

In this case, the lease liability, which refers to the amounts not yet paid, included the four remaining instalments of HK$440,000 discounted using the interest rate implicit in the lease, that is, 10%. The lease liability, at the commencement date, was HK$1,394,741 (HK$440,000 $\div$ 1.1 + HK$440,000 $\div$ 1.1^2 + HK$440,000 $\div$ 1.1^3 + HK$440,000 $\div$ 1.1^4).

At the commencement date, a lessee measures the right-of-use asset at cost. The cost of the right-of-use asset starts with the amount of the initial measurement of the lease liability and make further adjustments.

In this case, the right-of-use asset includes: (i) the amount of the initial measurement of the lease liability; and (ii) any lease payments made at or before the commencement date. The total amount of right-of-use asset recognised at the commencement date was then HK$1,834,741 (HK$1,394,741 + HK$440,000).

On 1 April 2017, the journal entries would be:

Dr. Right-of-use asset (ROU)	HK$1,834,741	
Cr. Lease liability		HK$1,394,741
Cr. Cash		HK$ 440,000

After the commencement date, the periodic lease payments would then be apportioned between the finance charge and the reduction of the lease liability. The total finance charges would be allocated to each period during the lease term so as to produce a constant period rate of interest on the remaining balance of the liability. On 31 March 2018, the journal entries would be:

Dr. Interest expense *(HK$1,394,741 x 10%)*	HK$139,474	
Cr. Lease liability		HK$139,474
Dr. Lease liability	HK$440,000	
Cr. Cash		HK$440,000

The right-of-use asset is depreciated over its lease term (in PEL's case, over the lease term of 5 years on a straight-line basis). On 31 March 2018, the journal entries would be:

Dr. Depreciation expense *(HK$1,834,741 ÷ 5 years)*	HK$366,948	
Cr. Accumulated depreciation: ROU		HK$366,948

Question 1(b)

In accordance with HKAS 1 (Revised) *Presentation of Financial Statements*, an entity classifies a liability as current when the liability is due to be settled within twelve months after the reporting period.

The lease liability balance of HK$1,094,215 as at 31 March 2018 should be apportioned as follows:

<u>Current liabilities</u>	
Current portion of lease liability	HK$330,579*
(HK$440,000 – HK$1,094,215 x 10%)	
<u>Non-current liabilities</u>	
Lease liability	HK$763,636
(HK$1,094,215 – HK$330,579)*	

Question 2(a)

HKFRS 16 requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date. At the commencement date, a lessee measures:

(i) the lease liability at the present value of the lease payments that are *not paid* at that date. In discounting such lease payments, the discount rate will be the interest rate implicit in the lease or the lessee's incremental borrowing rate if the interest rate implicit in the lease cannot be readily determinable; and

(ii) the right-of-use asset at cost. The cost of the right-of-use asset starts with the amount of the initial measurement of the lease liability.

In this case, the lease contract between Lemon Ltd. and Ginger Ltd. involved variable lease payments based on an index (i.e. the CPI). Such lease payments were:

- included in the measurement of the lease liability;
- measured using the prevailing index or rate at the commencement date;
- discounted at Lemon Ltd.'s incremental borrowing rate.

The initial measurement of the lease liability could be computed using the following schedule:

Payment date	Lease payment (HK$)		Discount factor		Present value (HK$)
31 March 2019	480,000	÷	$(1 + 6\%)^1$	=	452,830
31 March 2020	480,000	÷	$(1 + 6\%)^2$	=	427,198
31 March 2021	480,000	÷	$(1 + 6\%)^3$	=	403,017
	Lease liability at commencement date				1,283,045

The lease liability recognised by Lemon Ltd., on 1 April 2018, was HK$1,283,045. The right-of-use asset recognised by Lemon Ltd. at the commencement date was the same (without any further adjustment). The pair of journal entries made by Lemon Ltd. on 1 April 2018 was:

Dr. Right-of-use asset (ROU) 1,283,045
Cr. Lease liability 1,283,045
To initially recognise the right-of-use asset and lease liability

<u>Question 2(b)</u>

After commencement date, a lessee needs to measure:

(i) the lease liability using the effective interest method; and

(ii) the right-of-use asset at its cost less accumulated depreciation.

At 31 March 2019, the lease liability was measured subsequently as follow:

Date	Payment (HK$)	Interest expense in profit or loss (HK$)	Reduction in the balance (HK$)	Carrying amount (HK$)
1 April 2018				1,283,045
31 March 2019	480,000	1,283,045 x 6% = 76,983	480,000 – 76,983 = 403,017	1,283,045 – 403,017 = 880,028

On 31 March 2019, Lemon Ltd. paid HK$480,000 for its first lease payment. Out of this HK$480,000, HK$76,983 related to the interest on the lease liability (HK$1,283,045 x 6%) while the remaining portion HK$403,017 (HK$480,000 – HK$76,983) reduced the lease liability balance.

On 31 March 2019, the right-of-use asset has been depreciated over the lease term (three years) at an annual charge of HK$427,682 (HK$1,283,045 ÷ 3 years) in profit or loss.

On 31 March 2019, Lemon Ltd. prepared the following pairs of journal entries:

Dr. Interest expense (P/L) 76,983
Cr. Lease liability 76,983
To recognise the interest expense associated with the lease during the first year accompanied by an increase in the lease liability

Dr. Lease liability 480,000
Cr. Cash 480,000
To recognise the first lease payment with a reduction in the lease liability

Dr. Depreciation expense 427,682
Cr. Accumulated depreciation: ROU 427,682
To recognise the annual depreciation expense for the first year associated with the right-of-use asset in profit or loss

HKFRS 16 requires that if there is a change in the cash flows for future payments resulting from a change in index or rate used to determine the lease payments, the lessee is then required to remeasure the lease liability. For this remeasurement, the lessee first determines the revised lease payments for the remaining lease term based on the revised contractual payments and discounts such revised lease payments with an unchanged discount rate.

In this case, the CPI increased from 120 to 125. There would be an increase in the cash flows for future payments. The lease liability (together with the right-of-use asset) would be remeasured. The revised payments for the subsequent years, starting from the second year will be HK$500,000 (HK$480,000 x 125 ÷ 120). The adjustment was the difference between:

- the original lease payments (HK$480,000); and
- the revised lease payments (HK$500,000), discounted over the remaining two years at the original discount rate 6%:

Payment date	*Extra* lease payment (HK$)		Discount factor		Present value (HK$)
31 March 2020	20,000*	÷	$(1 + 6\%)^1$	=	18,868
31 March 2021	20,000	÷	$(1 + 6\%)^2$	=	17,800
			Total		36,668

(Note: HK$500,000 – HK$480,000)*

On 31 March 2019, Lemon Ltd. prepared the following pairs of journal entries:

Dr. Right-of-use asset (ROU)	36,668	
Cr. Lease liability		36,668

To remeasure the lease liability and the right-of-use asset due to a change in the CPI

After the remeasurement, the balances of the lease liability and the right-of-use asset as at 31 March 2019 were HK$916,696 (HK$880,028 + HK$36,668) and HK$892,031 (HK$1,283,045 – HK$427,682 + HK$36,668) respectively.

<u>Question 2(c)</u>

At 31 March 2020, the lease liability was measured subsequently as follow:

Date	Payment (HK$)	Interest expense in profit or loss (HK$)	Reduction in the balance (HK$)	Carrying amount (HK$)
1 April 2018				1,283,045
31 March 2019	480,000	76,983	403,017	880,028
Remeasurement				36,668
Adjusted carrying amount				916,696
31 March 2020	500,000	916,696 x 6% = 55,002	500,000 – 55,002 = 444,998	916,696 – 444,998 = 471,698

On 31 March 2020, the right-of-use asset has been depreciated over the remaining two years at an annual charge of HK$446,016 (HK$892,031 ÷ 2 years) in profit or loss.

On 31 March 2020, Lemon Ltd. prepared the following pairs of journal entries:

Dr. Interest expense (P/L)	55,002	
Cr. Lease liability		55,002

To recognise the interest expense associated with the lease during the second year accompanied by an increase in the lease liability

Dr. Lease liability	500,000	
Cr. Cash		500,000

To recognise the second lease payment with a reduction in the lease liability

Dr. Depreciation expense	446,016	
Cr. Accumulated depreciation: ROU		446,016

To recognise the annual depreciation expense for the second year associated with the right-of-use asset in profit or loss

Question 2(d)

HKFRS 16 provides practical expedient to the lessee accounting (i.e. not to recognise a lease liability and a right-of-use asset at lease commencement), under the following two circumstances:

(i) Short-term leases; or
(ii) Leases of low-value assets

The lease for Model V qualified as a short-term lease as it is a lease, at commencement date, has a lease term of 12 months or less.

If Lemon Ltd. elects not to apply the lessee accounting requirements to the lease for Model V, Lemon Ltd. will recognise the lease payment as an expense on a straight-line basis over the lease term (i.e. nine months) and consistently apply to all future short-term leases for similar leased asset.