

LEASES

IFRS 16 Leases

Lease:

- Right to control
- An identifiable asset
- Obtain the economic benefits from it

Not a lease if:

- Lessor can substitute asset for their own benefit: there is no identifiable asset

Exemption election:

- Leases < 12m with no purchase option
- Low value and not part of bigger asset (phones, laptops)
- Rent expensed to P&L

Lease Liability

Initial Recognition

- Liability initially measured at:
 - Future payments discounted to PV

	Payment	Discount Factor/EIR	PV
Yr1	X	X	X
Yr2	X	X	X
Yr3	X	X	X
			X

Subsequent Measurement - Amortised Cost:

B/F	Interest Expense	Cash	C/F
X	X	(X)	X
PV of LP (above)	Discount factor/EIR	Payment made	
Cr Liability, Dr PPE (ROU asset)	Cr Liability, Dr Finance Costs	Dr Liability, Cr Cash	

- EIR will increase the initial liability to the actual amount of cash paid

Right-of-Use (ROU) Asset

Initial Recognition

- Capitalised as part of PPE (ROU Asset):
 - Future payments discounted to PV (lease liability above)
 - Upfront payments (e.g. deposits, payments in advance)
 - Costs directly attributable to leasing asset
 - Costs to dismantle asset and restore land (provision)
 - Deduct any payments (lease incentives) from lessor

Subsequent Measurement

- Depr over period company will use asset

Sale and Leaseback (Proceeds = FV)

- Company sells an asset and immediately leases it back
- Sells an asset: profit/loss on disposal
- Leases an asset: ROU asset and lease liability
- Has only sold part of the asset because has retained a ROU for the asset
 - Can only recognise profit/loss on disposal for part sold
 - Example: sold freehold but now has a leasehold - the difference is the part disposed
- Part of asset which has been retained and part which has been sold calculated as:
 - PV of future lease payments / FV = part retained
 PV of LP = £80k
 FV = £100k
 80% of asset has been retained
 20% of asset has been sold

Profit/Loss on disposal

Proceeds (Dr)	X
CA (Cr)	(X)
Profit/Loss	X/(X)
20% (Cr/Dr)	X/(X)

ROU Asset (Dr)

CA x 80%

Lease Liability

B/F	Interest Expense	Cash	C/F
X	X	(X)	X
PV of LP	Discount factor/EIR	Payment made	
Cr Liability	Cr Liability, Dr Finance Costs	Dr Liability, Cr Cash	

- EIR will increase the initial liability to the actual amount of cash paid

If sale does not transfer control

- Sells asset and has option/obligation to repurchase it
- Sells asset but has retained risks and rewards of ownership (control not transferred)
 - Repurchase price \geq original selling price:
 - substance over form: loan with asset used as security, not a sale of an asset
 - cash received is a loan (financial liability)
 - additional amount paid is interest expense
 - asset continues to be recognised

RISK	PROCEDURES/EVIDENCE
Risk that leases are unrecorded (understated) or amount under/overstated:	
Leases not disclosed on SFP	Inspect contract to assess if lessee has right to control an identifiable asset
Incorrect measurement of lease liability	Inspect contract to verify payments to be made Recalculate implicit interest rate/PV of LP Recalculate interest expense using implicit interest rate Agree payments to bank statements Inspect notes and disclosures and ensure in accordance with IFRS 16
Incorrect measurement of ROU asset	Inspect schedule of capitalised costs and ensure directly attributable Agree transaction costs to bank statement Review correspondence between lessor and lessee to ensure that any dismantling/removal costs included in ROU asset Obtain contract and ensure asset depr over lease term (or UEL if reasonable certainty that lessee will own asset)
Sale and leaseback Risk of understatement of asset and lease liability and overstatement of profit if sale incorrectly recognised	Inspect contract to assess if control transferred and confirm terms Engage an expert/review recent sales of similar assets to determine FV Recalculate portion of asset disposed and profit to be recognised Agree cash received to bank statements

EXAM TECHNIQUE GUIDANCE

Questions in the CRDA exam will often include a series of issues (transactions). For each issue, you will be required to do all or some of the following:

- Explain FR treatment
- Redraft extracts from financial statements
- Identify audit risks
- State audit procedures

Explain FR Treatment

- Brief abstract: relevant parts of relevant standards
- Application: apply standard to specific scenario, explain why current treatment is incorrect
- Financial Statement (FS) numbers: P&L/OCI/SFP impact, journal entry if requested
- Correct FS extracts if required for next part of question

Audit Risks

- Use scenario narrative **and** numbers (AP) to identify risks of overstatement / understatement
- Try to combine scenario narrative and numbers
- Use FR knowledge to identify potential misstatements (common accounting errors)
 - There is a risk that profit is overstated because part of the asset has been retained via the leaseback so only a portion of the profit on disposal should be recognised

Audit Procedures

- When typing procedures, think: action; source; purpose
 - action (inspect, recalculate/reperform, confirm, enquire, observe; observation is weaker than inspection/recalculation);
 - source (independent better than client);
 - purpose (what does it help confirm: assertions below)
 - Recalculate portion of asset disposed and profit to be recognised
 - Engage an expert/review recent sales of similar assets to determine FV
 - Inspect FS to ensure correcting entries made and all disclosures are complete
- Consider the direction of testing (source document to financial statements or financial statements to source document) depending on whether it is a risk of overstatement or understatement and the assertion.

When thinking of audit risks, it is useful to think which financial statement assertions could give rise to a misstatement. When thinking of procedures, it is useful to think which assertion the procedure is testing. However, you do not need to always state which assertion you are testing with a particular procedure.

Assertions	
P&L	
Occurrence	Transactions recorded in FS have occurred
Completeness	All transactions have been recorded and all related disclosures in FS
Accuracy	Amounts recorded correctly in FS
Cut-off	Transactions recorded in the correct period
Classification	Transactions classified correctly in FS
Presentation	Presented correctly on FS with disclosures
SFP	
Existence	Assets/liabilities/equity exist
Rights and Obligations	Right to control assets/obligation to pay cash
Completeness	All assets/liabilities/equity have been recorded and all related disclosures in FS
Accuracy/Valuation	Amounts recorded correctly in FS
Classification	Transactions classified correctly in FS
Presentation	Presented correctly on FS with disclosures

MASTER PLAN

TOPIC	VIDEO CLASS	QUESTIONS	ICAEW Workbook
Leases	Leases	Q30 Limerick – Issue 1 Q31 Meitner – Issue 2 Q32 MilloMops – Issue 1 Q35 Brisco – Issue 2 Q36 Whitlock – Issue 2 Q39 Advent – Issue 2	Chapter 9.2-9.3

Key

Small topic

Medium topic

Large topic

Questions are in the ICAEW Question Bank

SAMPLE - NOT FOR USE

ACA Masters Question: Hillington (view video [here](#))

1. FR treatment

Under IFRS 15, a sale is recognised if control is transferred to purchaser.

If an asset is sold and leased back, part of the asset has been retained under the lease. Therefore, a P/L on disposal is only recognised for the part of the asset sold.

70% of the asset has been sold so only 70% of the P/L on disposal is recognised. It was incorrect to record the proceeds in revenue.

30% of the asset has been retained so continues to be recognised as a ROU asset.

CA	£1,200,000	
Sold/FV	£1,500,000	
PV of MLP	£449,612	
Retained %	30.0%	
Sold %	70.0%	
Proceeds	£1,500,000	
CA	(£1,200,000)	
P/L on disposal	£300,000	
70%	£210,078	
ROU Asset		
CA	£1,200,000	
30%	£359,690	

	Dr	Cr
Revenue - error	£1,500,000	
P/L on disposal		£210,078
PPE		£1,200,000
ROU Asset	£359,690	
Lease		£449,612
	£1,859,690	£1,859,690

Lease liabilities are initially measured at PV of future payments and subsequently under amortised cost. The effective interest is recorded as an expense in PL.

The liability is initially recognised at £449,612.

The interest expense for year is £24,279.

Dr PL Interest	£24,279
Cr Lease	£24,279

The lease payment (£105k) reduces liability. It was incorrect to record this in PL.

Cr Admin - error	£105,000
Dr Lease	£105,000

The liability cf is £368,891: £283,811 is NCL and £85,080 is CL.

	CF	DF	5.4%	PV	
1	£105,000	0.949		£99,620	
2	£105,000	0.900		£94,517	
3	£105,000	0.854		£89,674	
4	£105,000	0.810		£85,080	
5	£105,000	0.769		£80,721	
	£525,000			£449,612	
				£449,612	PV function
<u>Amortised cost:</u>					
<u>SFP</u>					
			5.4%		
	bf	int	paid	cf	
	£449,612	£24,279	(£105,000)	£368,891	£85,080
	£368,891	£19,920	(£105,000)	£283,811	
	£283,811	£15,326	(£105,000)	£194,137	
	£194,137	£10,483	(£105,000)	£99,620	
	£99,620	£5,380	(£105,000)	£0	

ROU asset is depr over 5-year lease term (£71,938 pa) because this is period company will use the asset.

The asset CA cf is £287,752.

Dr Depr	£71,938
Cr ROU Asset	£71,938
CA	£287,752

3. Audit procedures – sale and leaseback

Inspect contract to assess if control transferred and confirm terms: 5-year lease, £105k payment

Engage an expert/review recent sales of similar buildings to determine £1.5m FV

Recalculate portion of asset disposed and profit to be recognised

Agree £1.5m cash received and £105k lease payment to bank statements

Recalculate implicit interest rate as 5.4%/PV of LP of £449,612

Inspect notes and disclosures and ensure in accordance with IFRS 16

Inspect FS to ensure correcting entries made

SAMPLE - NOT FOR USE