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IFRS® Standard 16 Leases



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CASE STUDY – IFRS 16 LEASES

Introduction

In order for entities to carry out their activities, they need various assets such as machinery, equipment, vehicles. Today, many entities prefer to use these assets by leasing instead of meeting them with their own resources. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and ensures lessees and lessors to provide relevant information in a manner that faithfully represents those transactions.

The aim of this case study is to discuss how leases should be recognized under IFRS and to provide an understanding of its effects on financial statements.

The Case Information

Founded in 1987 in Sinop, Turkey, Arena Logistics Company provides logistics services in road transport. The company, which started service with 3 trucks purchased on the date of its establishment and provides intercity road transportation services only in Turkey, has taken firm steps forward without compromising service quality and customer satisfaction and has become one of the leading companies in the sector. In 2010, it started to provide logistics services in international road transport with 21 trucks it acquired. The company, whose business grew even more towards the end of 2020, decided to rent 10 trucks in order to meet the demands. Arena Logistics Company leased 10 trucks from Boras Company on January 1, 2021 to use in logistics activities. The following matters are included in the contract between Arena Logistics Company and Boras Company:

- The term of the lease contract is 5 years and the annual implicit interest rate is 6%.
- Arena Logistics Company will pay CU300,000 on contract date (January 1, 2021) and CU1,000,000 at the end of each year (from December 31, 2021).
- The ownership of the trucks will pass to Arena Logistics Company at the end of the contract.
- The leased trucks have a useful life of 5 years and have no residual value.
- Arena Logistics Company will apply a straight-line depreciation method for these trucks.

Discussion Questions

1. How should Arena Logistics Company (lessee) and Boras Company (lessor) recognize leases in 2021?
2. How will this lease affect Arena Logistics Company's and Boras Company's statement of financial position and statement of profit or loss in 2021?

SOLUTION OF CASE STUDY- IFRS 16 LEASES

First of all, this lease needs to be classified for the lessee and the lessor. For the lessee, this contract is a long-term lease for which the underlying asset is not of low value. Therefore, it should be reported on the statement of financial position. For the lessor this is a finance lease because some of the finance lease conditions are met on this agreement. For example; leased assets ownership will be transferred at the end of the agreement.

Firstly, we must calculate the annuity factor (AF) and the present value (PV) of the payments to be made for the lease contract.

$$AF = \frac{1 - (1 + r)^{-n}}{r}$$

r: Interest rate, n: Number of periods

Since the term of the lease contract is 5 years and the implicit annual interest rate is 6%,

$$AF = \frac{1 - (1 + 0.06)^{-5}}{0.06} = 4.212$$

Present Value (PV) = Cash Payment + (Annuity x $AF_{n=5, i=6\%}$)

Present Value (PV) = 300,000 + (1,000,000 x 4.212)

Present Value (PV) = CU4,512,000

Now, let's prepare the table of liability and interest payment.

Date	Total Payment (CU)	Discount factor	Present value of payment (CU)
01.01.2021	300,000	1	300,000
31.12.2021	1,000,000	0,943	943,000
31.12.2022	1,000,000	0,89	890,000
31.12.2023	1,000,000	0,84	840,000
31.12.2024	1,000,000	0,792	792,000
31.12.2025	1,000,000	0,747	747,000
TOTAL	5,300,000		4,512,000

Date	Principal Liability at the Beginning of the Period (CU)	Total Payment (CU)	Interest Payment (Liability*0.06) (CU)	Principal Payment (Total Payment-Interest Payment) (CU)	Principal Liability at the End of the Period (CU)
01.01.2021	4,512,000	300,000	0	300,000	4,212,000
31.12.2021	4,212,000	1,000,000	252,720	747,280	3,464,720
31.12.2022	3,464,720	1,000,000	207,883	792,117	2,672,603
31.12.2023	2,672,603	1,000,000	160,356	839,644	1,832,959
31.12.2024	1,832,959	1,000,000	109,978	890,022	942,937
31.12.2025	942,937	1,000,000	56,576	942,937	0
TOTAL		5,300,000	787,513	4,512,000	

Arena Logistics Company is the lessee and will recognize this lease on the statement of financial position.

Recognition of right-of-use asset in the statement of financial position

01.01.2021	Dr. Right-of-use Asset		4,512,000	
		Cr. Lease Liability		4,512,000

Payment on contract date

01.01.2021	Dr. Lease Liability		300,000	
		Cr. Bank		300,000

STATEMENT OF FINANCIAL POSITION, CU (01.01.2021)			
RIGHT-OF-USE ASSET	4,512,000	LEASE LIABILITY	4,212,000

Year-end interest expense

31.12.2021	Dr. Interest Expense		252,720	
		Cr. Lease Liability		252,720

Year-end payment (principal + interest)

31.12.2021	Dr. Lease Liability		1,000,000	
		Cr. Bank		1,000,000

Since the straight-line depreciation method is applied,
 Depreciation expense = CU4,512,000 / 5 years = CU902,400

31.12.2021	Dr. Depreciation Expense	902,400	
			Cr. Accumulated Depreciation
			902,400

STATEMENT OF FINANCIAL POSITION, CU (31.12.2021)			
RIGHT-OF-USE ASSET	4,512,000	LEASE LIABILITY	3,464,720
ACCUMULATED DEPRECIATION	(902,400)		

STATEMENT OF PROFIT OR LOSS, CU (01.01.2021 - 31.12.2021)	
OPERATING EXPENSES	
Depreciation Expense	(902,400)
FINANCE EXPENSES	
Interest Expense	(252,720)

Boras Company is the lessor and will recognize this lease as a finance lease.

Recognition of lease receivable in the statement of financial position

01.01.2021	Dr. Lease Receivables	4,512,000	
			Cr. PPE (underlying asset)
			4,512,000

Collection on contract date

01.01.2021	Dr. Bank	300,000	
			Cr. Lease Receivables
			300,000

STATEMENT OF FINANCIAL POSITION, CU (01.01.2021)		
LEASE RECEIVABLES	4,212,000	

Year-end interest income

31.12.2021	Dr. Lease Receivable	252,720	
			Cr. Finance Income
			252,720

Year-end collection (principal + interest)

31.12.2021	Dr. Bank	1,000,000	
			Cr. Lease Receivables
			1,000,000

STATEMENT OF FINANCIAL POSITION, CU (31.12.2021)		
LEASE RECEIVABLES	3,464,720	

STATEMENT OF PROFIT OR LOSS, CU (01.01.2021 - 31.12.2021)	
FINANCE INCOME	252,720