Adoption of Ind AS 17 Lease Standard and Its Implementation Challenges

Ministry of Corporate Affairs (MCA) notified the roadmap for implementation of converged IFRS (i.e. Ind AS) effective from 1st April, 2015. Implementation of the converged IFRS standards will be challenging for many entities and they might need to change the way they looked at the transactions under the Indian GAAP. Implementation of the converged IFRS standards would require numerous organisational and business changes and involvement from various departments and process owners of the entity. One such standard which the entity would need to look into detail is Ind AS 17-Leases. Read on to know more….

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The Ind AS 17 Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. The Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Assessment of lease standard typically requires the Companies to assess the substance of the transaction rather than the legal form of the arrangement. If a series of transactions involves the legal form of a lease and the economic effect can only be understood with reference to the series as a whole, then the series needs to be accounted for as a single transaction.

Risks and Rewards incidental to ownership

The classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

Para 10 of Ind AS 17 states "Examples of situations that *individually or in combination* would normally lead to a lease being classified as finance lease are":

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Analysis- It may be noted that Para 8 of earlier AS 19 states "Examples of situations which would normally lead to a lease being classified as finance lease". The word "individually or in combination" is a differentiating factor under Ind AS 17 and AS 19. Under Ind AS 17, the term individually or in combination is used, which means that even if one condition is satisfied the lease would be classified as a finance lease. However, examples and indicators mentioned above are not always conclusive. It may be noted that if it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease can still be classified as an operating lease.

Discount rate for determination of Minimum Lease Payments

In the books of Lessee's- The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used.

In the books of Lessor's– The present value of the minimum lease payments accruing to the lessor is computed at a market rate of interest.

Leases for Land and Buildings

Ind AS 17 specifically speaks about transactions when the lease includes both land and building. An entity needs to assess the classification of each element as a finance or operating lease separately. In determining whether the land element is an operating or a finance lease, an important consideration is that *land normally has an indefinite economic life*. Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump sum upfront payments) are allocated between the land and the buildings' elements in proportion to the relative fair values of the leasehold interests in the land element and buildings' element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

Appendix C to Ind AS 17: Determining whether an Arrangement contains a Lease

Background

An entity may enter into an arrangement, comprising a transaction or a series of related transactions,

If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

It may be difficult and even impracticable to determine the fair value of the asset acquired in the lease; however, the entity may elect to measure the asset capitalised under a finance lease at fair value at the date of transition in accordance with the optional exemption in Ind AS 101.

that does not take the legal form of a lease but conveys a right to use an asset (e.g. an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:

- outsourcing arrangements (e.g. the outsourcing of the data processing functions of an entity);
- arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity;
- take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).

Considerations of Appendix C to Ind AS 17:

Appendix C to Ind AS 17 addresses the following considerations:

(a) how to determine whether an arrangement is, or contains, a lease as defined in Ind AS 17;

(b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and

(c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Exemption under Ind AS 101– Determining whether an arrangement contains a lease:

Para D9 of Ind AS 101 states that "A first-time adopter may apply paragraphs 6-9 of "Appendix C of Ind AS 17 - Determining whether an Arrangement contains a Lease" to determine whether an arrangement existing at the date of transition to Ind ASs contains a lease on the basis of facts and circumstances existing at the date of transition to Ind AS, except where the effect is expected to be not material."

Analysis - There are no explicit exemptions or exceptions in Ind AS 101 from retrospective application of Ind AS 17 Leases. A first time adopter is therefore required to recognise all assets held under finance lease at the date of transition. If not previously recognised, this involves determining the fair value of the asset at the inception of the lease (or the present value of the minimum lease payments, if lower) depreciated to the date of transition and calculating the finance lease liability based on the net present value of the minimum lease payments, amortised using the rate implicit in the lease (or, in certain circumstances, the lessee's incremental borrowing rate). It may be difficult and even impracticable to determine the fair value of the asset acquired in the lease; however, the entity may elect to measure the asset capitalised under a finance lease at fair value at the date of transition in accordance with the optional exemption in Ind AS 101.

Appendix C to Ind AS 17 specifies criteria for determining, at the inception of an arrangement, whether the arrangement contains a lease. It also specifies when an arrangement should be reassessed subsequently. Ind AS 101 provides an exemption from these requirements. Instead of determining retrospectively whether an arrangement contains a lease at the inception of the arrangement and subsequently reassessing that arrangement as required in the periods prior to transition to Ind ASs, entities may determine whether arrangements in existence on the date of transition to Ind ASs contain leases by applying paragraphs 6 to 9 of Appendix C to Ind AS 17 to those arrangements on the basis of the facts and circumstances existing at the date of transition, except where the effect is not expected to be material.

Hence, for the purpose of determining whether the arrangement existing at the date of transition to Ind ASs contains a lease, analysis need to be made based on the facts and circumstances existing at the date of transition. Once it is determined that the arrangement existing at the date of transition to Ind ASs contains a lease based on the facts and circumstances existing at the date of transition, then the assessment would be to determine whether the arrangement is a finance lease or an operating lease based on the substance of the transaction rather than

the form of the contract at the inception of the lease and not on the date of transition to Ind ASs.

Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset):-
Analysis- Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. For example, if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

(b) the arrangement conveys a right to use the asset:-
Analysis- An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:
(a) The purchaser has the *ability or right to operate the asset or direct others to operate* the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
(b) The purchaser has the *ability or right to control physical access to the underlying asset* while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Example- Arrangement that contains a lease
A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at the inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of gas each month.

The term insignificant is not defined under Ind AS. The entity has to determine what amounts to an insignificant amount of output or other utility of the asset on case to case basis at the time of assessment of each transaction under Appendix C to Ind AS 17.

If an arrangement contains a lease, the parties to the arrangement shall apply the requirements of Ind AS 17 to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of Ind AS 17.

- Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 % of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Assessment

The arrangement contains a lease within the scope of Ind AS 17 *Leases*. An asset (the facility) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented—in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Separating payments for the lease from other payments

If an arrangement contains a lease, the parties to the arrangement shall apply the requirements of Ind AS 17 to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of Ind AS 17. Accordingly, if an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with paragraphs 7–17 of Ind AS 17. Other elements of the arrangement not within the scope of IND AS 17 shall be accounted for in accordance with other Standards.

For the purpose of applying the requirements of Ind AS 17, payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements on the basis of their *relative fair values*. The minimum lease payments as defined in paragraph 4 of Ind AS 17 include only payments for the lease (i.e. the right to use the asset) and exclude payments for other elements in the arrangement (e.g. for services and the cost of inputs).

In some cases, separating the payments for the lease from payments for other elements in the arrangement will require the purchaser to use an estimation technique. For example, a purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.

Example - Separating payments for the lease from other payments

A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The Company charges ₹250,000/- per month which includes payments for the lease and payments for services and the cost of inputs.

A purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.

Assessment

As required by Appendix C to Ind AS 17, charges of ₹250,000/- per month received by the Company needs to be separated for payments for the lease (i.e. the right to use the asset) and payments for services and the cost of inputs. Suppose the fair value of lease payment amounts to ₹100,000/- and payment for services and the cost of inputs amounts to ₹150,000/-, then the amount of ₹100,000/- towards the lease payment only needs to be considered for the assessment of determination of lease and not the entire amount of ₹250,000/-.

Similarly, in the above example, if the determination of fair value of lease payment and other payment is not possible to be determined then the entity need to use the estimation technique to separate the payment for the lease from other payments.

It may be noted that Appendix C to IND AS 17 deals only with whether the arrangement contains a Lease or not. It does not deal with whether the arrangement is a finance lease or an operating lease. Hence, based on the terms and conditions of the agreement/arrangement, it is concluded that the arrangement contains a lease, one needs to go back to Ind AS 17 to determine whether the arrangement is a finance lease or operating lease.

Other factors that need to be considered for Classification of Leases

The standard requires an entity to assess the classification of leases as finance or operating leases in accordance with the general rules in paragraphs 7-13 given in Ind AS 17. The standard takes a more principles-based substance over form approach and list down the examples and indicators that would normally lead to a lease being classified as a finance lease. The classification of leases adopted in the standard is based on the extent to which the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include possibility of losses from idle capacity or technological obsolescence and rewards may be represented by the expectation of profitable operation over the asset's economic life and a gain from appreciation in value or realisation of residual value. The economic life therefore include additional lease terms with the same or different lessees.

The difficulty tends to emerge on classifying leases where only one condition is fulfilled through the terms of lease, but the lessor retains all the elements of risk relating to the assets. The important point

would be that the tests mentioned in para 10 of IND AS 17 are not explicit requirement of the standard and should not be applied in isolation, but it may be a useful tool in practice in attempting to determine the economic substance of lease arrangement. Hence, one needs to apply other indicators regarding classification which are as follows -

- Transfer of ownership of asset at the end of lease term
- Whether bargain purchase option available with lessee
- Lease Term vs. Economic life of asset
- Whether the leased assets are of specialised nature
- Gain or losses from fluctuation in fair value of residual value – Residual value risk
- Ability of lessee to extend lease term of asset at substantially lower value than market value.

Hence, while determining whether the arrangement is a finance lease or an operating lease one needs to analyse the examples of situations mentioned in para 10 of Ind AS 17 along with the analysis of whether the risk and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

Conclusion

The implementation of Ind AS 17 standard would require the entity to relook at the transactions entered into by the entity in the past to determine whether an arrangement existing at the date of transition to Ind ASs contains a lease on the basis of facts and circumstances existing at the date of transition to Ind AS. If the arrangement contains a lease the arrangement need to be accounted for as per the principles of Ind AS 17. ■

To be able to lead others, a man must be willing to go forward alone. - Harry S. Truman