Accounting for Leases- Overview and Analysis of Exposure Draft on Ind AS 116, Leases

ICAI has issued an Exposure Draft on Ind AS 116 which will replace the Ind AS 17 on leases to keep Ind AS updated with revision made to IFRS and to continue convergence with IFRS 16. The Exposure Draft on lease is based on IFRS 16, except for a few changes. Once the new standard on leases will be notified by MCA, it is expected to have major impact on the entities and sectors that seek large volume of equipment financing and other companies with large lease portfolios. The key changes will increase the transparency and comparability in lease accounting. Read on to know more…

Introduction

The Ministry of Corporate Affairs (MCA) through a notification dated 16th February, 2015 issued the Companies (Indian Accounting Standards) Rules, 2015 (Ind AS Rules) which laid down a road map for entities (other than insurance entities, banking entities and Non-Banking Financial Companies (NBFCs)) (corporate road map) for implementation of Ind AS converged with International Financial Reporting Standard (IFRS) in a phased manner and notified 40 Ind AS which included Ind AS 17, leases.

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Internationally, on 13th January, 2016, the International Accounting Standards Board (IASB) issued IFRS 16, *Leases.* The new Standard represented a fundamental shift in accounting for leases, specifically for lessees. Additionally, it is expected to increase transparency and comparability of published financial information as analysts and investors would be able to see a company's own assessment of its lease liabilities, calculated using a prescribed methodology under Ind AS.

IFRS 16 is effective from 1st January, 2019, with early application being permitted (as long as IFRS 15, *Revenue from Contracts with Customers* is also applied).

New development

On 18th July, 2017, the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft (ED) of Ind AS 116, Leases. Ind AS 116 is largely converged with IFRS 16.

Ind AS 116 is expected to replace Ind AS 17 from its proposed effective date, being annual periods beginning on or after 1 April 2019.

Difference between Ind AS 17 and exposure draft on Ind AS 116

Ind AS 116	Ind AS 17
1. Definition of a lease	
Lease is 'a contract or part of a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. An underlying asset has been defined to mean an asset that is the subject of lease, for which the right to use that asset has been provided by a lessor or lessee.	Ind AS 17 defined lease as 'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.'
2. Accounting by lessee	
The Ind AS 116 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee would be required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.	Ind AS 17 requires classification of leases as finance lease and operating lease.
Subsequently, a lessee would be required to measure right-of-use assets like other non-financial assets (such as property, plant and equipment) and lease liabilities like other financial liabilities. A lessee would recognise depreciation expense on the right-of-use asset and interest expense on the lease liability.	**Under Ind AS 17, for operating leases, lessee is required to recognise the lease payments as an expense on a straight line basis unless another systematic basis is representative of the time pattern of the user's benefit.**
3. Accounting by lessor The accounting treatment for lessor in Ind-AS 116 is similar to the accounting requirements in Ind AS 17. A lessor would continue to classify its leases as operating leases or finance leases, and would account for those two types of leases differently. However, the additional disclosure requirements for lessors as compared to Ind AS 17, such as, disclosure of maturity analysis of lease payments; quantitative and qualitative explanation of significant changes in carrying amount of new investment in finance leases, etc.	

Additional Guidance in Ind-AS 116

The Ind AS 116 provides additional guidance on the following aspects:

• **Identified asset and substitution rights (paragraph B14 of Ind AS 116):** A contract contains a lease only if it relates to an identified asset. While an asset may continue to be explicitly or implicitly specified in a contract, a lessee would not have control over the use of an identified asset if the lessor has a substantive right to substitute the asset throughout the period of use. A lessor's substitution right is considered to be substantive if throughout the period of use, the lessor:

a) Has the practical ability to substitute the asset, and

b) Would benefit economically from exercising its right to substitute the asset

Further, an entity's evaluation of whether a supplier's substitution right is substantive should be based on facts and circumstances at the inception of the contract and should exclude consideration of future events that, at inception of the contract, are not considered likely to occur **(paragraph B16 of Ind AS 116).**

• **Right to obtain economic benefits from use (paragraph B21 of Ind AS 116):** A customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use in order to control the use of an identified asset. Such an economic benefit could be obtained from the use of an asset directly or indirectly, such as by using, holding or sub-leasing the asset.

• **Right to direct the use of an asset (paragraph B24 of Ind AS 116):** Similar to IFRS 16, under the proposed standard, a customer has the right to direct the use of an identified asset throughout the period of use only if meets any of the given criteria:

a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use. While making this assessment, an entity considers the decision making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use.

b) The relevant decisions about how and for what purpose the asset is used are predetermined and:

   i. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions, or

   ii. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

Provision for lease modification

Ind AS 116 contains specific provisions for lease modification for lessor and lessee.

Lease modification by a lessee:

A lessee should account for a lease modification as a separate lease if both the given conditions are met:

a) The modification increases the scope of the lease by adding the right to use one or more underlying assets, and

b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Further, for a lease modification that is not accounted for as a separate lease, the lessee should account for the remeasurement of the lease liability by:

a) Decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee should recognise in the statement of profit and loss any gain or loss relating to the partial or full termination of the lease.

b) Making a corresponding adjustment to the right-of-use asset for all other lease modifications.

Lease modification by a lessor :

Finance lease:

A lessor should account for a modification to a finance lease as a separate lease if both the given conditions are met:

a) The modification increases the scope of the lease by adding the right to use one or more underlying assets, and

b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Further, for a finance lease that is not accounted for as a separate lease, a lessor should account for the modification in the following manner:

a) If the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor should:

   i. Account for the lease modification as a new lease from the effective date of the modification, and

   ii. Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

c) Otherwise, the lessor should apply the requirements of Ind AS 109, Financial Instruments.

Operating lease

A lessor should account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Ind AS 17 does not specifically provide how to account for lease modification.

Presentation

A lessee shall either present in the balance sheet, or disclose in the notes:

(a) right-of-use assets separately from other assets.

(b) lease liabilities separately from other liabilities.

If right-of-use assets meet the definition of investment property, then it shall be presented in the balance sheet as investment property in accordance with the Ind-AS 40.

In the statement of profit and loss, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of Ind AS 1, Presentation of Financial Statements, requires to be presented separately in the statement of profit and loss.

In the statement of cash flows, a lessee shall classify:

(a) cash payments for the principal portion of the lease liability within financing activities;

(b) cash payments for the interest portion of the lease liability within financing activities applying the requirements in Ind AS 7, Statement of Cash Flows, for interest paid; and

(c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Presentation in Balance Sheet/or disclosure in notes	Statement of Profit and Loss	Statement of Cash Flows
right-of-use assets separately from other assets	present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset	cash payments for the principal portion of the lease liability within financing activities
lease liabilities separately from other liabilities	Interest expense on the lease liability as a component of finance costs	cash payments for the interest portion of the lease liability within financing activities applying the requirements in Ind AS 7, Statement of Cash Flows, for interest paid
		short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities

Accounting of Lease by Lessee as per Ind-AS 116

Example —Measurement by a lessee

Initial measurement of the right-of-use asset and the lease liability

Lessee enters a 5-year lease of a floor of a building, with an option to extend for five years. Lease payments are CU 1,00,000 per year during the initial term and CU 1,10,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, Lessee incurs initial direct costs of CU 20,000, of which CU5,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU 5,000. At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 5 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 5-year term, and with similar collateral. At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives lease incentives from Lessor and measures the lease liability at the present value of the remaining four payments of CU 100,000, discounted at the interest rate of 5 per cent per annum, which is CU 354,595.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset	CU 454,595	
Lease liability		CU 354,595
Cash (lease payment for the first year)		CU 100,000
Right-of-use asset	CU 20,000	
Cash (initial direct costs)		CU 20,000
Cash (lease incentive)	CU 5,000	
Right-of-use asset		CU 5,000

Calculation of right-of-use asset and the lease liability from Year 1 to Year 5 are as follows.

	Lease liability				Right of Use assets		
Year	Year Beginning balance	CU Lease payment	CU 5% interest expense	CU Ending balance	CU Beginning balance	CU Depreciation charge	CU Ending balance CU
1	354595	0	17730	372325	469595	(93919)	375676
2	372325	(100000)	13616	285941	375676	(93919)	281757
3	285941	(100000)	9297	195238	281757	(93919)	187838
4	195238	(100000)	4762	100000	187838	(93919)	93919
5	100000	(100000)	0	0	93919	(93919)	0

Conclusion

After implementation of Ind AS 116, treatment of lease accounting in the books of lessee will change significantly. A lessee would be required to recognise a right-of-use asset and a lease liability in balance sheet and recognise depreciation expense on the right-of-use asset and interest expense on the lease liability except where lease is with a term which is less than 12 months, or the underlying asset is of low value. As a result there is likely increase in the reported assets and liabilities by lessee, which will have significantly impact on the financial ratios of the entity. ■

References: Exposure Draft issued by ICAI on Ind AS 116.

All progress takes place outside the comfort zone *- Michael John Bobak*