Indian Accounting Standard 116 - *Leases*

Ind AS 116 is expected to align Indian Accounting Standard on leases to corresponding international accounting requirements under IFRS and US GAAP. The new standard would help in improving the comparability of lease accounting of Indian entities with its global peers in similar industries. Under the new standard, lessee is no more required to classify lease arrangements as operating or finance lease. Ind AS 116 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases except for short-term leases and leases of low value assets. Ind AS 116 is expected to impact most companies across sectors with the figures of Property, Plant and Equipment, financial liabilities and EBITDA expected to increase as compared to earlier standard i.e. Ind AS 17. Read on to know more…

Background

The Accounting Standard Boards (ASB) of the Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft of Ind AS 116 – Leases ('Ind AS 116'). Ind AS 116 is proposed to be effective from annual period beginning on or after April 1, 2019 and is expected to replace the existing standard under Ind AS namely Ind AS 17 – Leases ('the existing standard').

This new standard on leases sets out principles for recognition, measurement, presentation and disclosure of leases. The objective of Ind AS 116 is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions and provides a basis to the users of the financial statements to assess the impact the leases will have on the financial position, financial performance and cash flows of the entity.

CA. Pravin Sethia

The author is a member of the ICAI. He can be reached at sethiapravin@gmail.com or eboard@icai.in

Upon notification of Ind AS 116 with effective date of April 1, 2019, listed entities reporting their quarterly results will be required to apply the requirements of this new standard for the quarter ending June 30, 2019 and onwards.

Key Differences between Ind AS 116 and Ind AS 17

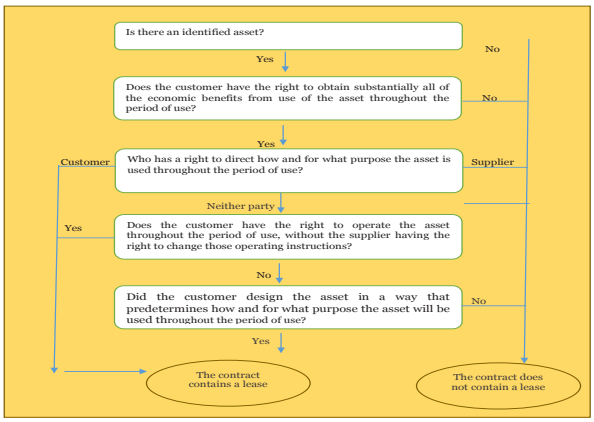
Ind AS 116, 'leases' has been issued to align with global standards on leases namely IFRS 16 and ASC 842 under IFRS and US GAAP respectively.

Key Differences between Ind AS 116 and the existing standard on Leases - Ind AS 17 are as under:

Sr. No	Ind AS 17	Ind AS 116
1	Ind AS 17 defines 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.	Ind AS 116 defines Leases as a contract, or part of a contract, that conveys the right to control the use of an underlying asset for a period of time in exchange for consideration. Accordingly, unlike Ind AS 17, in order to qualify a contract as a lease, the customer must have the right to direct the use of the identified asset to obtain substantially all the economic benefits from use of identified assets.
2.	Ind AS 17 required leases to be classified as finance lease and operating lease. It specifies separate accounting model for lease classified as operating lease and finance lease.	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 is 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.
3.	Under Ind AS 17, lessee in case of operating lease is required to recognise the lease payments as expense on a straight-line basis unless another systematic basis is more representative of the time pattern of the user's benefit.	Under Ind AS 116, a lessee measures right-of-use assets similar to other non-financial assets (such as property, plant and equipment) and lease liabilities similar to other financial liabilities. As a consequence, a lessee recognises depreciation on the right-of-use asset and interest on the lease liability. Lessee also classifies repayments of the lease liability into a principal and an interest portion and presents them in the statement of cash flows applying Ind AS 7, Statement of Cash Flows.
4.	Ind AS 17 does not specifically provide for accounting of lease modification.	Ind AS 116 contains specific provision for accounting of lease modification by lessee and lessor.

Identifying Lease Arrangement

At the inception of the contact, an entity is required to assess whether the contract is or contains a lease based on certain conditions specified in the standard. The relevant conditions for assessment of lease are summarised in the below flow chart.



Accounting by Lessee :

A) Recognition and Initial measurement

- Lessee shall recognise a right-of-use asset and a lease liability at the commencement date (i.e. date on which the lessor makes the asset available for use by lessee).
- The lease liability is measured at the present value of unpaid lease payment on the commencement date for the lease term. The lease payments are discounted using interest rate implicit in the lease or lessee's incremental borrowing rate in case implicit interest rate is not readily determinable.
- The right-of-use asset is required to be measured at cost comprising of the following:

a) the amount of lease liability recognised as above

b) lease payments made at or before the

commencement date net of any lease incentives received

c) any initial direct costs incurred by the lessee, and

d) initial estimate of restoration costs as per terms and conditions of the lease.

- One of the most significant changes introduced by Ind AS 116 is the new model of lease accounting by lessee. Unlike Ind AS 17, which prescribes two separate model of accounting by lessee for operating lease and finance lease, Ind AS 116 introduces a single accounting model and requires a lessee 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.
- The above model of accounting under Ind AS 116 would result in significant increase in the amount of assets and financial liabilities in the financial statements of entities having substantial lease arrangements, which were earlier classified as operating lease and not recognised on the balance sheet under Ind AS 17.

B) Subsequent measurement

- Subsequent to initial recognition, a lessee shall measure the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses, if any. The carrying amount of right-of-use asset also require adjustment for the change in the carrying value of lease liability to reflect impact of any reassessment or modification of lease arrangement.

  The right-of-use asset shall be depreciated in accordance with the requirement of Ind AS 16, Property, Plant and Equipment.

- Subsequent to the commencement date, the lessee shall measure the lease liability by increasing the carrying amount for the interest on lease liability and reducing the carrying amount for the lease payments. The carrying amount of Lease liability may be re-measured to reflect impact of any reassessment or modification of lease arrangement.

Accounting by Lessor:

- The accounting treatment under Ind AS 116 for lessor is substantially the same as under the existing standard. The lessor continues to classify the lease as either finance lease or operating lease depending on the terms of the lease contract on transfer of substantially all the risk and reward incidental to ownership of the underlying asset.
- The accounting treatment by lessor depends on whether the lease is classified as finance lease or operating lease. In case of operating lease, the lessor continues to recognise the asset in its books and recognise the lease rentals as income. In case of finance lease, the lessor derecognizes the underlying asset from its books and recognises the receivables representing lessor's net investment in the lease in the Balance sheet.
- Lessor also recognises finance income in the statement of profit and loss representing a constant periodic rate of return on lessor's net investment in the lease over the lease term.

Illustrative Example Explaining Accounting by Lessee

Company P (Lessee) entered into a lease arrangement for a period of 5 years with Company Q (Lessor) for occupying lessor's warehouse. The lease rental is ₹ 150,000 per year. The interest rate implicit in the lease is 5% per annum. It is assumed that there are no other terms like lease incentives, variable lease rental, initial direct cost, obligation for restoration costs, lessee's right to renew the arrangement, etc., in the lease arrangement.

The warehouse has a remaining useful life of 30 years and fair value of ₹ 50 lakhs. It is assumed that the above lease arrangement is an operating lease under Ind AS 17.

The net present value of lease rentals of INR 150,000 for a period of 5 years at 5% discount rate amounts to ₹ 649,422.

On the commencement date, Company P recognises a lease liability and right-of-use assets of ₹ 649,422 in its balance sheet. The below table summarises the treatment of above lease arrangement under Ind AS 116 in Balance Sheet and Statement of Profit and Loss of lessee.

Amount in ₹

	Lease Liability				Right-of-use Asset		
Period	Opening Balance	Lease Payment	Interest Expenses	Closing Balance	Opening Balance	Depreciation	Closing Balance
Column	1	2	3 (1*5%)	4 (1-2+3)	5	6	7 (5-6)
At Inception	649,422	-	-	649,422	649,422	-	649,422
Year 1	649,422	(150,000)	32,471	531,893	649,422	(129,884)	519,538
Year 2	531,893	(150,000)	26,595	408,488	519,538	(129,884)	389,654
Year 3	408,488	(150,000)	20,424	278,912	389,654	(129,884)	259,770
Year 4	278,912	(150,000)	13,946	142,858	259,770	(129,884)	129,886
Year 5	142,858	(150,000)	7,142	-	129,886	(129,886)	-
Total		**750,000**	**100,578**			**649,422**	

Amount in ₹

	As per Ind AS 116			Ind AS 17		
Period	Interest Expense	Depreciation	Total Expenses	Lease rental Expenses	Impact on Net Income*	Impact on EBITDA*
Column	1	2	3 (1+2)	4	5 (4-3)	6
Year 1	32,471	129,884	162,355	150,000	(12,355)	162,355
Year 2	26,595	129,884	156,479	150,000	(6,479)	156,479
Year 3	20,424	129,884	150,308	150,000	(308)	150,308
Year 4	13,946	129,884	143,830	150,000	6,170	143,830
Year 5	7,142	129,886	137,028	150,000	12,972	137,028
Total	**100,578**	**649,422**	**750,000**	**750,000**	-	**750,000**

* (Positive figures and figures in the bracket indicate favorable and adverse impact respectively on amount of net income/EBITDA under Ind AS 116 as compared to Ind AS 17.)

As per above example, whereas under Ind AS 116, Company P recognises interest expenses on lease liability and depreciation on right-of-use assets in the statement of profit and loss, it would recognise the operating lease rental expenses under Ind AS 17 as a part of operating expenses. Accordingly, Ind AS 116 is expected to have a favourable impact on EBITDA as compared to Ind AS 17.

Further, while in the initial years the total expenses comprising of depreciation and interest expense under Ind AS 116 is expected to be higher as compared to lease rental expense under Ind AS 17, the total expenses over the lease term under Ind AS 116 and Ind AS 17 will remain at the same level.

Impact on Presentation and Disclosures

Particulars	Lessee	Lessor
Presentation in Balance Sheet	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. Right-of-use assets meeting the definition of investment property shall be presented as Investment property in the balance Sheet.	**Operating Lease**: Lessor shall present underlying assets in its balance sheet according to the nature of the underlying asset. **Finance Lease**: Lessor shall present net investment in the lease as receivable in the balance sheet.

Presentation in statement of profit and loss	Lessee shall present interest expense on lease liability and depreciation charge on right-of-use separately in the statement of profit and loss.	Lessor shall present lease rental income in case of operating lease or finance income in case of finance lease in the statement of profit and loss.
Disclosures	Some of the key disclosure requirements for lessee involves disclosing amounts relating to the reporting period for the following items : • Depreciation charge for right-of-use assets. • Interest expenses on lease liabilities. • Expenses relating to short term/low value assets accounted on straight line or other systematic basis over lease term. • Additions and carrying value of right-of-use assets. • Gain/loss arising from sale and lease back transactions.	**Operating lease:** Lessor is required to disclose separately the amounts for lease income and variable lease payments that do not depend on an index or a rate. **Finance lease** : lessor is required to disclose amounts for : • Profit/loss on sale of assets • Finance income on net investment in the lease.

Transition consideration

Appendix C to Ind AS 116 provides for transition considerations in applying the new standard. An entity may choose to apply any one of the following approaches to apply the requirement of Ind AS 116:

a) **Full retrospective application:** Entity can apply the requirements of Ind AS 116 retrospectively for each prior reporting period presented in accordance with Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'. Accordingly, the entity shall adjust the opening balance of equity for the earliest prior period presented (i.e adjust the retained earnings as at April 1, 2018) and the other comparative amounts disclosed for each prior period presented (i.e restate the comparative figures of FY 2018 -2019) as if the requirements of Ind AS 116 had always been applied.

b) **Cumulative catch up application :** Under this approach, the entity recognises the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings/other component of equity of the accounting period that includes the date of initial application. Accordingly, an entity with 31st March year end shall recognise the cumulative effect of applying Ind AS 116 as an adjustment to its retained earning as at April 1, 2019. An entity may choose to apply certain practical expedients stated in Appendix C to Ind AS 116 while applying cummulative catch up approach.

As a practical expedient, an entity is not required to reassess the existing lease contracts (whether previously identified as containing/not containing lease under Ind AS 17) to evaluate whether a contract is, or contains, a lease at the date of initial application.

Accounting for Lease modification

- Ind AS 116 provides detailed guidance on accounting for lease modification.
- Lease modification is accounted as a separate lease by lessee and lessor if the modification increases the scope of the lease by adding one or more right-of-use assets **and** the consideration for the lease increases commensurate with the adjusted stand-alone price for the increased scope.
- In the event, lease modification is not accounted as separate lease:
  a) Lessee re-measures the lease liability by discounting the revised lease payments using revised discount rate and the re-measured lease liability is accounted by adjusting the carrying amount of the right-of-use asset.

b) If the lease (initially classified as finance lease) would have been classified as operating lease had the modification been in effect at the inception date, lessor accounts for lease modification as a new lease and measures the carrying amount of the underlying asset given on operating lease at the amount of net investment in the lease immediately before the date of lease modification.

c) In case the lease would continue to have been classified as finance lease in spite of lease modification, the lessor accounts for modification as extinguishment of original financial liability and recognition of new financial liability as per the requirement of Ind AS 109.

Industries Impacted by Ind AS 116

Ind AS 116 is expected to impact entities across all industries although the extent of impact may vary for each industry depending on the extent of leasing arrangements prevalent in that industry. Industries that are likely to get significantly impacted by Ind AS 116 are summarised below :

Industry	Key impacting areas
Retail Industry	• The retail industry is likely to be one of the most impacted by Ind AS 116 as generally stores, retail outlets, shopping arcade, etc., use lease model (rather than owned model) for their operations. • Ind AS 116 would result in significant increase in debt (lease liabilities) on the balance sheet of companies in retail industry as most of their leases would now be recognised 'on' the balance sheet. In the income statement, there will be sizable increase in the EBITDA as the lease rentals will now be replaced by finance cost and depreciation. • The lease agreement in the retail industry generally involve complex terms around variable lease payments based on store revenue or other parameters, renewal options, bundled contract comprises of lease and non-lease component (like maintenance), obligation for restoration costs,relocation costs, etc. Companies in the retail industry would need to carefully evaluate these terms in lease arrangement to ensure appropriate accounting under Ind AS 116.
Airline Industry	• Leasing is an essential element of aircraft financing as companies in airlines industry rely heavily on leased aircraft. • Ind AS 116 is expected to have major impact on airline industry resulting in significant increase in the debt (lease liabilities) and change in profile of statement of profit and loss of entities in airline industry. • Further, in majority of cases, the lease arrangement in airline industry are entered in US dollars. The lease liabilities denominated in foreign currency would required to be translated at each reporting date resulting in significant increase in foreign currency risk exposures for such entities with consequent volatility in the statement of profit and loss arising due to change in the foreign currency exchange rates.
Other Industries	• Other industries expected to get significantly impacted by Ind AS 116 include Telecommunication, Healthcare, Shipping and Industrial products.

Summary:

Ind AS 116, once notified by MCA, will significantly change the lease accounting by lessees as compared to current Ind AS and will result in most leases (excluding leases of short term and low value assets) recognised 'on' the balance sheet of the lessee. The new standard is expected to influence certain key performance matrices like EBITDA, Return on capital employed (ROCE), gearing ratio, net profit, earning per share etc., monitored by various stakeholders. Larger the lease portfolio of entities, greater could be the impact of Ind AS 116 on above key performance matrices.

Considering the proposed effective date of April 1, 2019, companies, more particularly listed companies with large lease portfolios, would need to start early to assess the accounting and tax impact of the new standard on its financial results for current and comparative periods. Companies would also need to a) evaluate and determine their transition approach b) review, and if required update, their existing terms of lease contracts and c) make changes to their IT systems, processes and internal controls to capture the required information to meet the recognition, measurement and disclosure requirements of Ind AS 116.

It will be interesting to observe whether Ind AS 116 would result in shift in the operational decisions of entities in terms of outright purchase verses leasing the assets for their operations. ■

**Source/Reference:*

1. Exposure draft of Ind AS 116 – Leases, issued by the ASB of ICAI

The best way to find yourself is to lose yourself in the service of others. - Mahatma Gandhi