The Chamber of Tax Consultants

Ind AS 116 – Leases

CA Hemal Shah

Contents

Overview and Scope

Ind-AS 116 *Leases*
Overview

Ind AS 116 is notified on March 29, 2019 with applicability for period beginning April 01, 2019
Major changes in the standard are as below -

Key changes primarily affecting lessees

- Recognise assets and liabilities for most leases
- New presentation and disclosure requirements

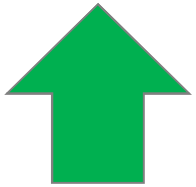
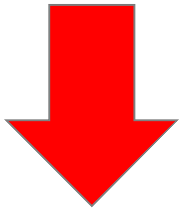
Lessors

- Accounting substantially the same

Ind-AS 116 *Leases*
Overview

		Ind AS 17		Ind AS 116
		Finance leases	Operating leases	All leases
Balance sheet	Assets	✓	–	✓
	Liabilities	✓	–	✓
	Rights and off-balance sheet items	–	✓	–
Profit and Loss	Revenue	X	X	X
	Other expenses	–	Lease expense	–
	EBITDA			↑
	Depreciation	✓	–	✓
	EBIT			↑
	Finance cost	✓	–	✓
	PBT	-	-	Initial years lower

Likely impact on key financial ratios

	P&L	BS	Ratios
	EBIDTA	Total assets	Gearing
	EPS (in initial years)	Net assets	Assets turnover, interest coverage

Recognition and Measurement

The new standard aims to achieve more transparency by mandating a single accounting model for all type of leases.

Key changes impact Lessees	A **Assets and liabilities recognition for most Leases**	B **New presentation and disclosure requirements**

Initial recognition and measurement	Measure Right of Use (RoU)[1] Asset and Lease liability at Present Value of lease payments
Subsequent measurement – **RoU Asset**	Depreciate ROU basis Ind AS 16 *Property, Plant and Equipment*; Alternative measurement under revaluation model (Ind AS 16)
Subsequent measurement – **Liability**	Increase the lease liability to reflect interest on Lease liability; Reduce the lease liability by payments made
Profit and Loss	Generally "front-loaded" expense for individual Leases; separate interest and depreciation presentation

Lessee's lease obligation – Borrowings vs. Financial Liability?

[1] Initial measurement of the ROU asset would also include the lessee's Initial Direct Costs, less lease incentives received from the lessor, and restoration and dismantling costs.

Initial direct costs

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained
Eg. Brokerage and commission for obtaining assets on lease

- Lessees and lessors apply the same definition of initial direct costs
- Ind AS 16’s requirements on Initial Direct Costs are consistent with the concept of incremental costs in Ind AS 115

Under Ind AS 116, Initial Direct Costs exclude costs that are incurred regardless of whether lease is obtained (e.g., certain legal advice).

Ind-AS 116 *Leases*
Overview

- **Scope exclusions**
  - Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
  - Leases of biological assets
  - Service concession arrangements
  - Licences of intellectual property granted by a lessor
  - Rights held by a lessee under certain licensing agreements (e.g., films, video recordings)

- **Recognition exemptions**
  - Short-term leases
  - Leases of low-value assets

Short-term leases

- Lessees – can use 'short-term lease' exemption
  - Not to recognise lease assets or liabilities on the balance sheet
  - To recognise lease expense on a straight-line or another systematic basis
- Applies to leases with a **lease term** of 12 months or less
- To be applied by class of underlying assets
- Lease term include periods covered by an option to extend the lease, if the lessee is **reasonably certain** to exercise that option
- A lease that contains a purchase option does not qualify

Example: non-cancellable lease term of nine months with a four-month renewal option (assume no purchase option)

Exercise of option is reasonably certain = not short-term lease

Exercise of option is <u>not</u> reasonably certain = short-term lease

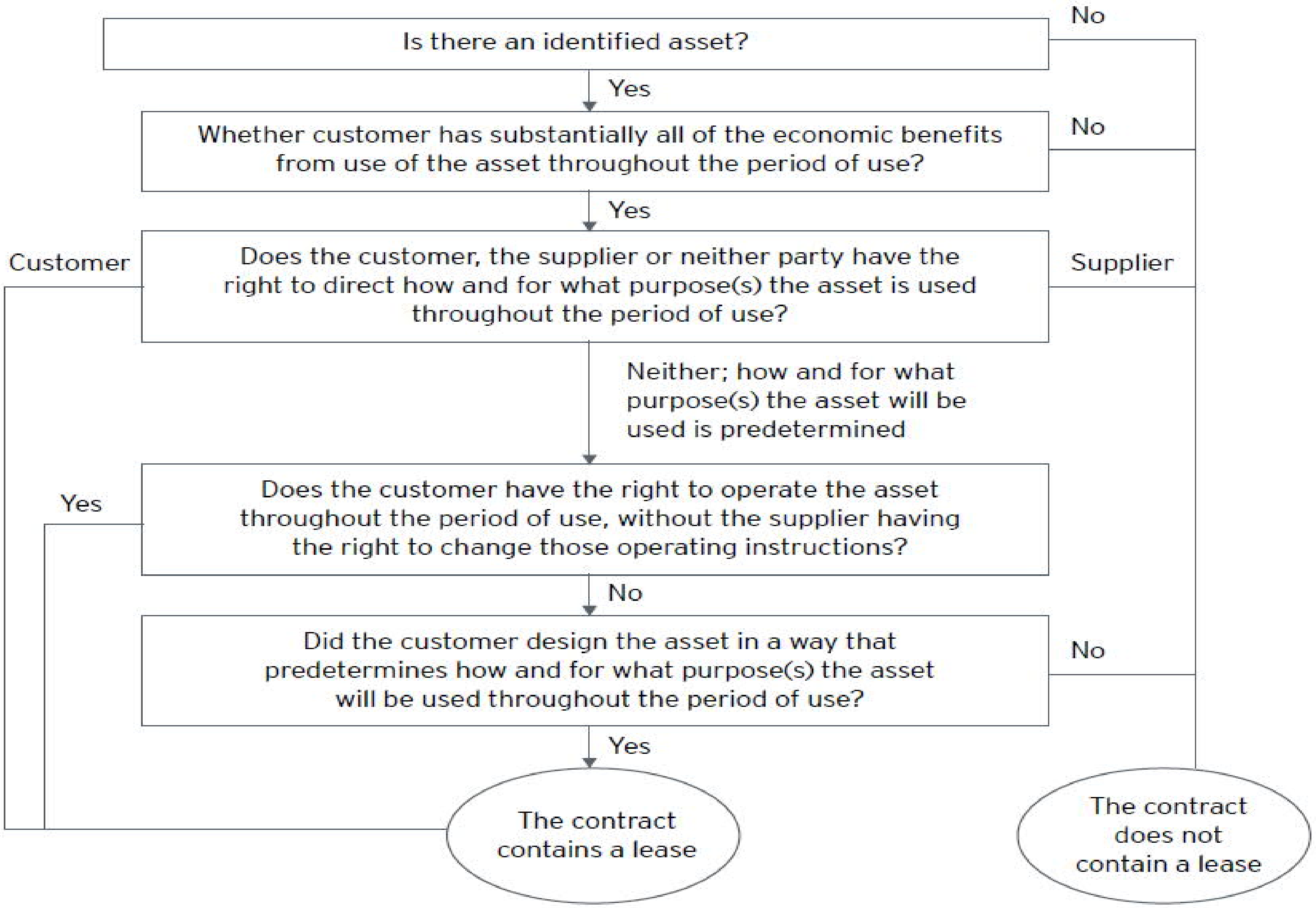
Nine months	**Four months**

Non-cancellable lease term | Optional renewal period

Recognition exemptions: Leases of low-value assets

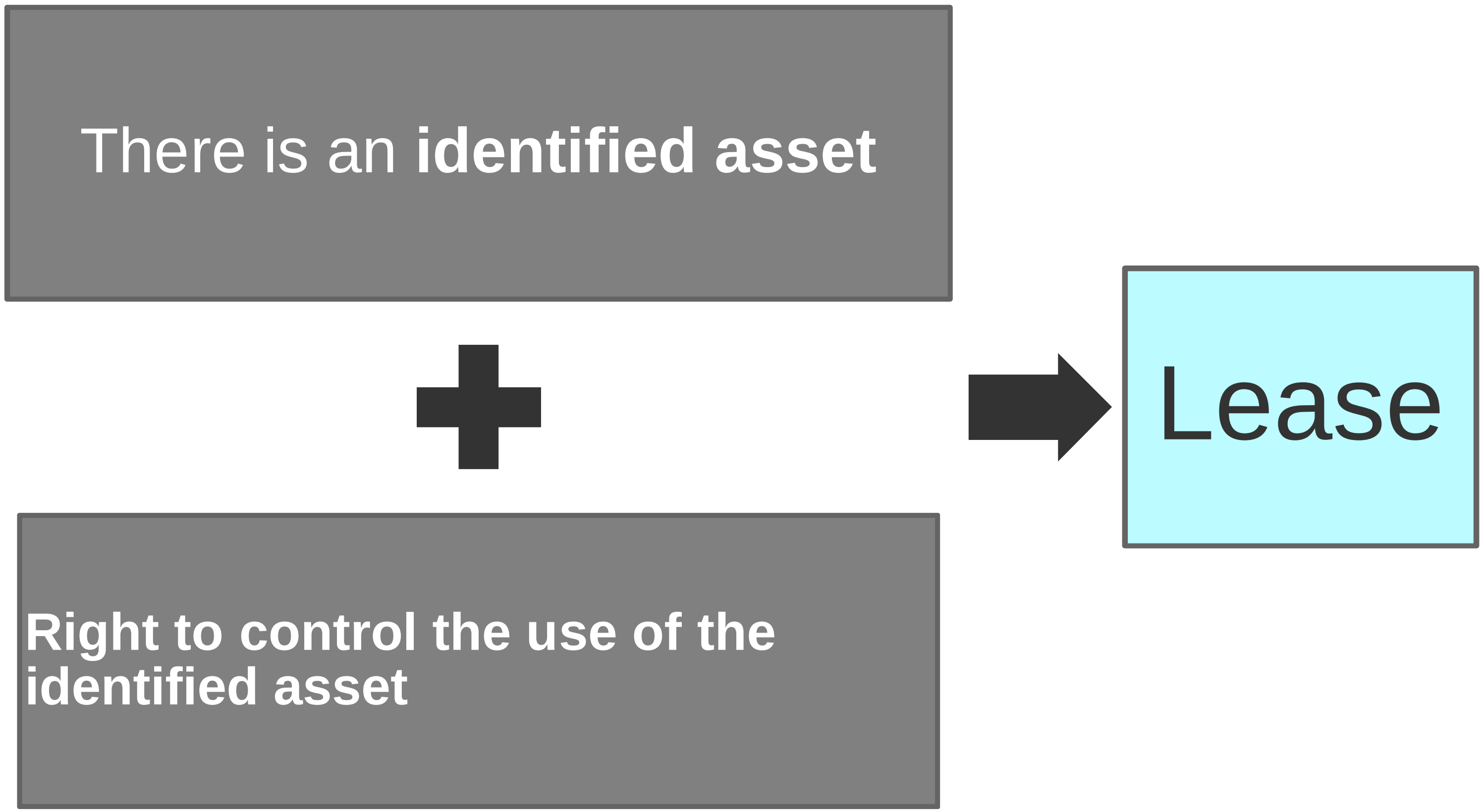
Accounting	► **No BS lease assets or liabilities** ► **Lease expense on a straight-line or another systematic basis**
Applicability	Applies to assets that are not dependent on, or highly interrelated with other assets
Assets group	Can be applied on lease-by-lease basis
New or old asset?	Based on the value of asset when it is new
Sub-lease	Doesn’t apply to head lease, if the lessee subleases or expects to sublease the asset
Example	► Small IT equipment (laptops, mobile phones, basic printers), ► Office furniture (such as chairs, desks and office partitions); ► Water dispensers Big Relief for ► Professional services firm that leases personal IT equipment for its staff ► IT companies
Car lease	May not qualify

Flowchart for determining whether an arrangement is or contains a lease



Definition of a lease

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.



Definition of a lease – Identified Assets

- There is no identified asset if the supplier has a substantive substitution right

Substitution Right

Practical ability to substitute alternative assets **throughout the period of use**

+

Benefits > Costs

Evaluation of Substitution Right is substantive

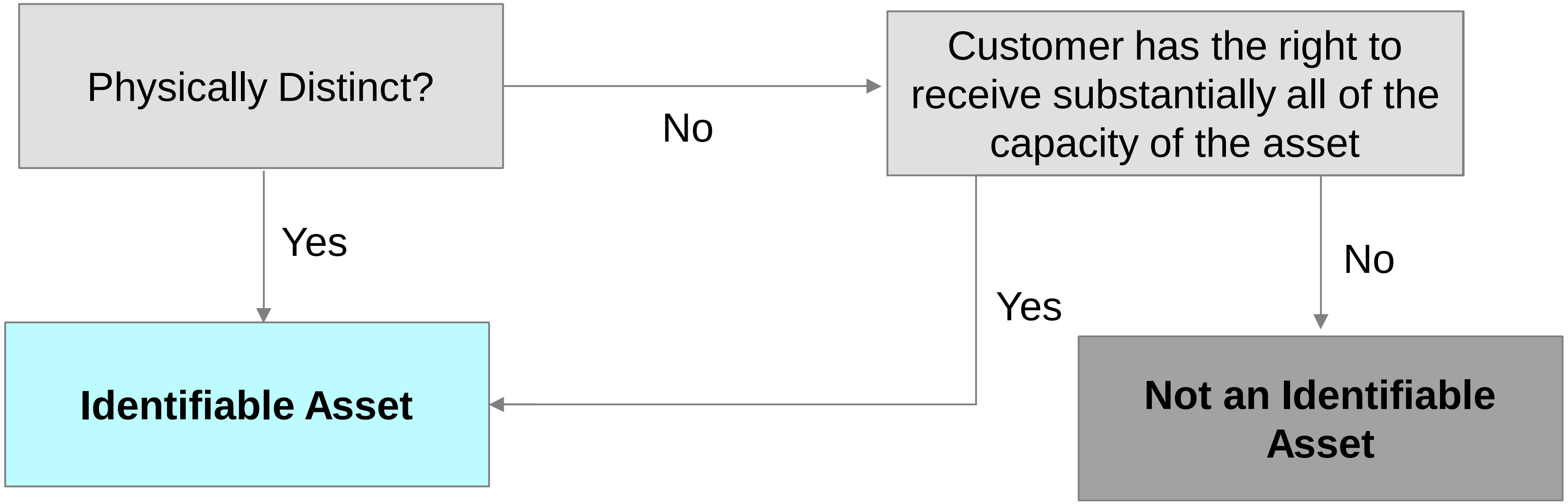
Are based on facts and circumstances at inception of the contract

Exclude consideration of future events that, at inception, are not considered likely to occur

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive

Definition of a lease – Identified Assets

- A portion of an asset's capacity can be an identified asset if:



- A supplier's protective rights (in isolation) do not prevent the customer from having the right to direct the use of an identified asset
- **An entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed**

Example – Identified asset – physically distinct portion of a larger asset

- Customer C enters into a 12-year contract with Supplier S for the right to use a fibre optic for data transmission cable between India and US

Scenario I – 3 out of 5 cables	Scenario II - 60% of the cables' capacity	Scenario III - 95% of the cable’s capacity
Physically distinct, as three fibres are dedicated solely to Customer C’s data.	Not physically distinct from the remaining capacity	Not physically distinct from the remaining capacity
Represents substantially all of the capacity of the pipeline taken by C	Less than substantially all of the capacity of the pipeline.	Represents substantially all of the capacity of the pipeline
An identified asset	**Not an identified asset**	**An identified asset**

Definition of a lease – Right to control

Right to control the use of the identified asset

Right to obtain substantially all the economic benefits

AND

Right to direct the use

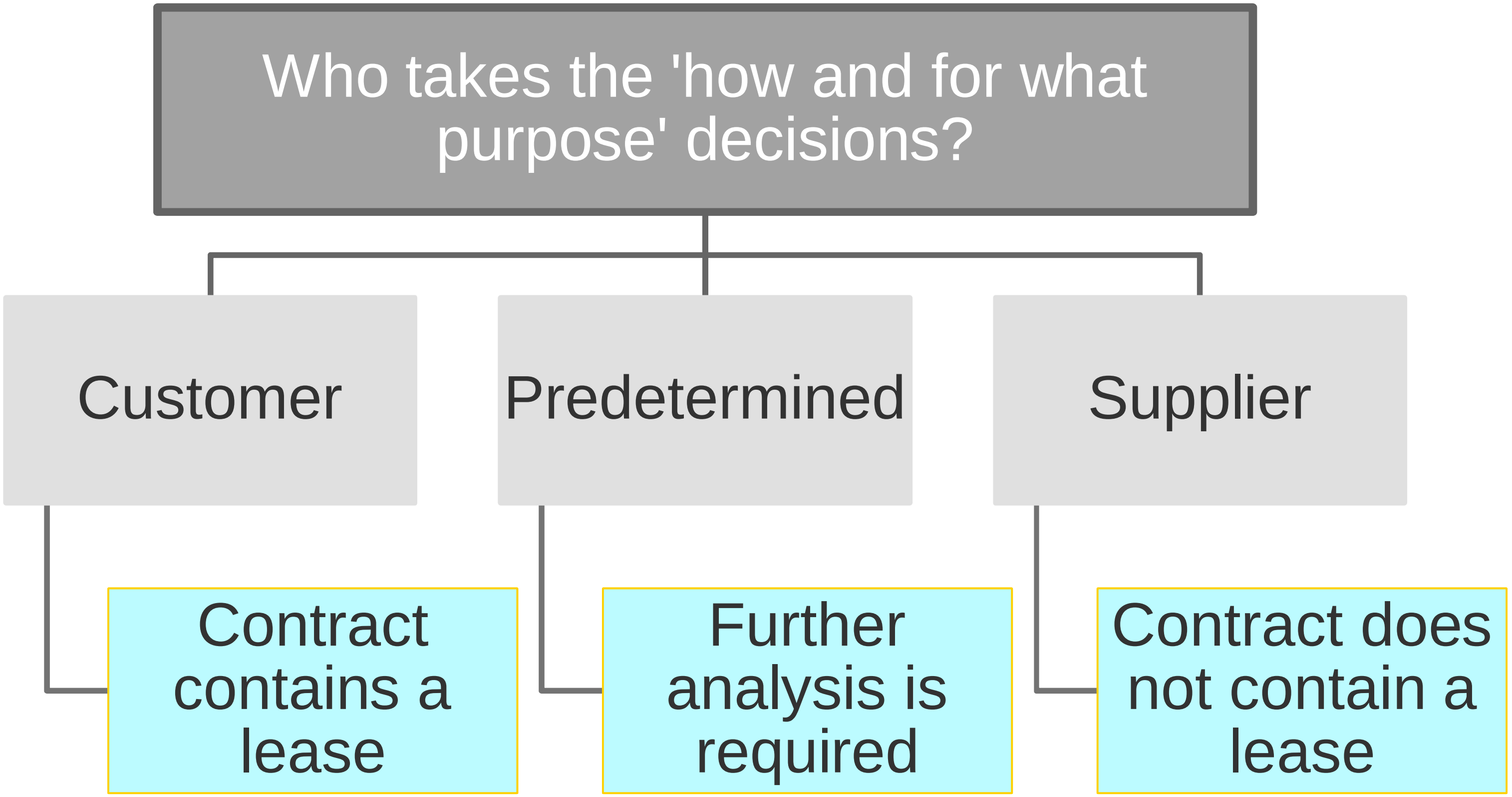
Customer has the right to direct how and for what purpose the asset is used

OR

Relevant decisions about how and for what purpose the asset is used are predetermined **AND**

- The customer has the **right to operate** the asset, without the supplier having the right to change those operating instructions; **OR**
- The customer **designed** the asset in a way that **predetermines** how and for what purpose the asset is used

Definition of a lease – Right to control



Lease Term

Determining the lease term

Non-cancellable period
(includes the period covered by an option to terminate the lease, only if the lessor has the right to terminate the lease)

Periods covered by option to extend the lease if the lessee is reasonably certain to exercise that option

Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

Reasonably certain assessment

Economic incentive to exercise?

- Favourable terms
- Significant leasehold improvements
- Termination or relocation costs
- Specialised asset of lack of available alternative assets
- Past practice
- Interaction with other contract terms
- Length of non-cancellable period

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.


Transition Approach

Transition Approach

- Lessee
  - Two Approaches
    - 1) Full Retrospective
    - 2) Modified Retrospective
      - 2A) **Lease liability** at present value of the remaining lease payments discounted using the lessee's incremental borrowing rate at the date of initial application
        ROU at its carrying amount, as if the standard had been applied since the commencement date
      - 2B) **Lease liability** at present value of the remaining lease payments discounted using the lessee's incremental borrowing rate at the date of initial application
        ROU at an amount equal to Lease Liability, adjusted by prepaid or accrued lease payments

Effective date and transition – Modified retrospective approach for lessees

Existing operating leases

- Lease liability = present value of remaining lease payments*
- Choice (lease-by-lease basis) of measurement of ROU asset:
  - As if Ind AS 116 had been applied since commencement date
  - Equal to lease liability adjusted for prepayments or accrued payments immediately before initial application

* Using incremental borrowing rate at the date of initial application

Existing finance leases

- Carry forward asset and lease liability from Ind AS 17
- Apply Ind AS 116 requirements from the date of initial application

Example - Transition Approach

- Entity H (lessee) enters into a five-year lease of equipment.
- Entity H agrees to make the annual payment of INR 1,000 at the end of each year.
- Transition to Ind AS 116 is year 3.

Accounting under Ind AS 17

- Rent expense of INR 1000 in every year for three years.

Accounting under Ind AS 116

MLP	Discounted@6%	Difference
1,000	943	57
1,000	890	110
1,000	840	160
1,000	792	208
1,000	747	253
5,000	**4,212**	**788**

	(A)	(B)	(C)	(D)	(E)
Date	**ROU**	**Depreciation**	**Lease liability**	**Interest expense**	**Repayment**
	Op-(B)		Op+(D)-(E)		
Initial recognition	4,212		4,212		
End of Year 1	3,370	842	3,465	253	1,000
End of Year 2	2,527	842	2,673	208	1,000
End of Year 3	1,685	842	1,833	160	1,000
End of Year 4	842	842	943	110	1,000
End of Year 5	-	842	-	57	1,000

Example - Transition Approach

IND AS 116 is applied in Year-3

Particulars	Full Retrospective	Modified Retrospective (A)	Modified Retrospective (B)
ROU Asset	3,370	2,527	2,673
Liability	3,465	2,673	2,673
Depreciation Year 1	842	-	-
Depreciation Year 2	842	842	891
Interest Expense Year 1	253	-	-
Interest Expense Year 2	208	160	160
Retained earnings	-95	-146	-

Key Concepts

Separating lease components

- Some contracts contain the right to use multiple underlying assets (e.g., a building and equipment, multiple pieces of equipment)

- There are 4 steps for accounting of components of the contract –

1. Identify the separate lease components
2. Identify any non-lease components ---- e.g. a maintenance or operating service
3. Measure the ‘consideration in the contract’.
4. Separate and allocate the consideration in the contract between the lease and non-lease components

Identify the separate lease components

Separate lease component

Lessee can benefit from ROU either:

- on its own; or
- together with other resources readily available to lessee

➕

ROU is neither:

- highly dependent on; nor
- highly interrelated with the other ROUs in the contracts

- ► If one or both criteria are **<u>not</u>** met, the right to use multiple assets is considered a single lease component
- ► For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the right to use the land is considered a separate lease component unless the accounting effect of separately accounting for the land element would be ‘insignificant’.

Separating lease and non-lease components

Contract

Lease Components	Non-lease Components	Not a Component
Allocate Consideration in the contract		Activities (or lessor costs) that do not transfer a good or service to the lessee

- Machine maintenance or common area maintenance is a non-lease component
- Reimbursement or payment of lessor's property taxes and insurance is an example of "not a component"

A determination that the contract involves a very significant service (i.e. non-lease) component, upon which effective use of the underlying asset depends, **does not change the conclusion that there is a lease.**

Example– Identifying and separating lease components of a contracts

- Lessee has taken Xerox machine on lease for 5 years
- Lessor also provides maintenance service
- Lessor obtains its own insurance for Xerox machine
- Annual lease rentals INR 2000 includes following:
  - Maintenance service INR 300
  - Insurance INR 50
- Lessee is able to determine that maintenance and insurance services are being offered by third parties at INR 400 and INR 50 respectively
- Observable standalone price is not available for Xerox machine with maintenance service

Solution

- Observable stand-alone price for maintenance services is 400
- No observable stand-alone price for the lease
- Insurance cost does not transfer a good or service to the lessee - not a separate lease component.

Therefore, Lessee allocates 1,600 (2,000 - 400) to the lease component

Measure the consideration in the contract

- Lease payments should be consistent with the lease term determination

Lessee				
Fixed payments, including in-substance fixed payments, less any lease incentives	Exercise price of a purchase option*	Payments for penalties for terminating the lease**	Variable lease payments that depend on an index or rate	Residual value guarantees***

- In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable

* Include only if reasonably certain of exercise

** Include unless reasonably certain that the lessee will not exercise an option to terminate the lease

*** Lessees use the amounts they **expect** to pay. Lessors include any guarantee.

Variable Lease payments

Types of variable lease payments	
Dependent on an index or rate	**Not dependent on an index or rate**
Included in the initial measurement of lease payments?	
Yes	**No**
► Examples include: Consumer Price Index or market interest rate ► Measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for the initial measurement) ► Lessees generally recognise changes to index- and rate-based variable lease payments as an adjustment to the right of use asset and the lease liability in the period of the change ► No guidance on subsequent measurement is provided for lessors	► Examples include: performance- or usage-based payments ► Lessees recognise such lease payments in profit or loss, unless the costs are included in the carrying amount of another asset, in the period in which the event or condition that triggers those payments occurs ► No guidance is provided for lessors

Lease term and lease payments – in-substance fixed variable lease payments

Question:

- At lease commencement, are variable payments based on revenue generated from the leased asset (e.g. sales at leased retail store) in-substance fixed payments, when it is highly probable that a certain level of revenue will be achieved?

- When payments have genuine variability, they are not fixed and therefore are excluded from the initial measurement of the lease liability even if the amount is highly probable

Allocating consideration in the contract : lessees and lessors

Lessee (On the basis of relative standalone price basis)

- Observable standalone prices are used when readily available
- Estimated standalone prices when observable standalone prices are not readily available, maximizing the use of observable information

Lessor

Lessors apply Ind AS 115 to allocate consideration in the contract between the lease and non-lease components of the contract

Presentation and Disclosure

Lessee accounting – Presentation

Balance sheet	Income statement	Cash flow statement
ROU asset: ► Separately from other assets (e.g., owned assets), Lease liability: ► Separately from other liabilities	► Interest expense presented separately from depreciation ► Present or disclose: ► Variable lease expense ► Short-term lease expense ► Low-value asset lease expense	► Principal payments within financing activities ► Interest payments consistent with policy election in Ind AS 7 *Statement of Cash Flows* ► Lease payments for low-value assets, short-term leases and variable lease payments (not included in the lease liability) within operating activities ► Supplemental non-cash disclosure of new leases

Lessor accounting – Presentation

Finance leases	Operating leases
Assets held under a finance lease are presented as a Finance Lease receivable.	Underlying assets subject to operating leases are presented according to the nature of the asset

Important Considerations

Discount Rate

Discount rates are used to determine the present value of the lease payments, which are used to determine lease classification and to measure a lessor's net investment in the lease and a lessee's lease liability.

For a lessee, the discount rate for the lease is the interest rate implicit in the lease and, if that rate cannot be readily determined, its incremental borrowing rate.

For a lessor, the discount rate for the lease is the interest rate implicit in the lease.

Subleases

- A transaction for which an underlying asset is re-leased by a lessee (intermediate lessor) to a third party, and the lease (head lease) between the head lessor and lessee remains in effect.

Lessor (A)

↓ Head lease

Original lessee/intermediate lessor (B) →

↓ Sublease

Lessee/sub-lessee (C)

- No change to its accounting for the head lease, unless exemption for low-value assets lease was used
- Sublease is classified, as follows:
  - If the short-term lease exemption is elected for the head lease, the sublease is classified as an operating lease
  - Otherwise, the sublease is classified by reference to the ROU asset arising from the head lease, rather than by reference to the underlying asset

- If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of low-value asset.

Example – Sublease

- Head lease — An intermediate lessor enters into a 5-year lease for equipment (the head lease) with Entity A (the head lessor).
- Useful life of an equipment is 15 years
- Sublease
  - Scenario I - At the beginning of Year 3, the intermediate lessor subleases equipment for the remaining three years of the head lease to a sublessee.
  - Scenario 2 - At commencement of the head lease, the intermediate lessor subleases the equipment for two years to a sublessee.

Analysis

- The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease

Scenario I	Scenario II
Finance Lease	Operating Lease
3 years vs 3 years	2 years vs 5 years

Sale and leaseback transactions

Determine whether the transfer of the asset is a sale:

- Apply Ind AS 115
- Presence of a leaseback does not preclude a sale
- A substantive repurchase option does preclude sale

Transfer of the asset is a sale

Seller-lessee:

- Derecognise the underlying asset
- Recognise the sale at fair value
- Recognise only the gain/loss that relates to the rights transferred to buyer-lessor
- Measure the ROU asset at the retained portion of the previous carrying amount of underlying asset
- Recognise a lease liability
- Buyer-lessor:
- Recognise the transferred asset
- Apply lessor accounting for the leaseback

Transfer of the asset is not a sale

Seller-lessee:

- Continue to recognise the underlying asset
- Recognise a financial liability – Ind AS 109
- Buyer-lessor:
- Do not recognise the transferred asset
- Recognise a financial asset under Ind AS 109 equal to transfer proceeds

Interest free refundable security

How should the lessee account for the security deposit?

Analysis

- It is a financial asset because it is ‘collateral’ provided to the lessor
- Does not meet the definition of a lease payment because it is not a payment relating to the right to use the underlying asset.
- Accounted for as per Ind AS 109 i.e. @ fair value
- Difference between nominal amount and its fair value represents prepaid lease payment – added to the initial carrying amount of the RoU asset

Other Considerations

Other considerations

- Accounting Treatment of Rent Equalisation Liability at the time of transition to IND AS 116
- Presentation of ROU Assets
- Lease restoration liability to be recognized as part of RoU assets
- GST not reimbursable – not to be part of ROU
- Deferred tax adjustment to be considered for differences arising between accounting balance sheet and tax balance sheet on implementation of Ind AS 116.
- Lease Liability – Borrowing or Financial Liability
- Lease modification
- Portfolio application
- Impact of Ind AS 116 on
  - Compliance with Related party transactions
  - Implementation of ICFR
- Impact on inventory valuation

Disclosures in Jun-19 Quarterly Results of Jubilant Foodworks Ltd.

- Ind AS 116 - Leases, has become applicable effective annual reporting period beginning April 1, 2019. The Group has adopted the standard beginning April 1, 2019, using the modified retrospective approach for transition. Accordingly, the Group has not restated the comparative information, instead the cumulative effect of initially applying the standard has been recognised as an adjustment to the opening balance of retained earnings as on April 1, 2019. This has resulted In recognising (including reclassification from other assets) a "Right of use asset" of Rs.1,29,577.38 lakhs and a corresponding "Lease liability" of Rs.1,59,087.69 lakhs by adjusting retained earnings net of taxes of Rs.24,381.54 lakhs (including impact of "Deferred tax asset" created of Rs.12,926.97 Iakhs) as at April 1,2019. In respect of leases that were classified as operating leases, on applying Ind AS 17, Rs. 7,798.20 lakhs has been reclassified from "Other assets" to "Right of use asset".
- Consequently in the statement of profit and loss for the current period, the nature of expenses in respect of operating leases has changed from lease "Rent"/"Other expenses" in previous period to "Depreciation and amortisation expense" for the right of use assets and "Finance cost" for interest accrued on lease liability. As a result the "Rent”/"Other expenses", "Depreciation and amortisation expense" and "Finance cost" of the current period is not comparable to the earlier periods.

Disclosures in Jun-19 Quarterly Results of Jubilant Foodworks Ltd.

- To the extent the performance of the current period is not comparable with previous period results, the reconciliation of above effect on statement of profit and loss for the quarter ended June 30, 2019 is as under:

Adjustments to Increase/(Decrease) in Net Profit	Quarter ended 30th June, 2019 comparable basis	Changes due to IND AS 116	Quarter ended 30th June, 2019 as reported
Rent	9,326.31	(7,199.19)	2127.12
Other expenses	29,002.96	(74.00)	28,928.96
Depreciation & Amortisation expense	3,902.92	4,355.48	8,258.40
Finance cost	26.27	3,967.10	3,993.27
Profit before tax	12,128.20	(1,049.39)	11,078.81
Less: Tax expense	4,293.25	(362.62)	3,930.63
Profit after tax	7,834.95	686.77	7,148.18

Thank you