Date: Feb 2021

VIRTUAL COACHING CLASSES
ORGANISED BY BOS, ICAI

FINAL LEVEL
PAPER 1: FINANCIAL REPORTING

TOPIC: IND AS 116
LEASES

Faculty: CA Alok K Garg

Origin

2005
- SEC Staff Paper recommending FASB and IASB to revisit accounting guidance for leases

2016
- IASB introduced IFRS 16 replacing IAS 17 and related interpretations
- Made effective from 1 Jan 2019

2019
- 30 March 2019, MCA notified Ind AS 116 replacing Ind AS 17
- Made effective from 1 April 2019

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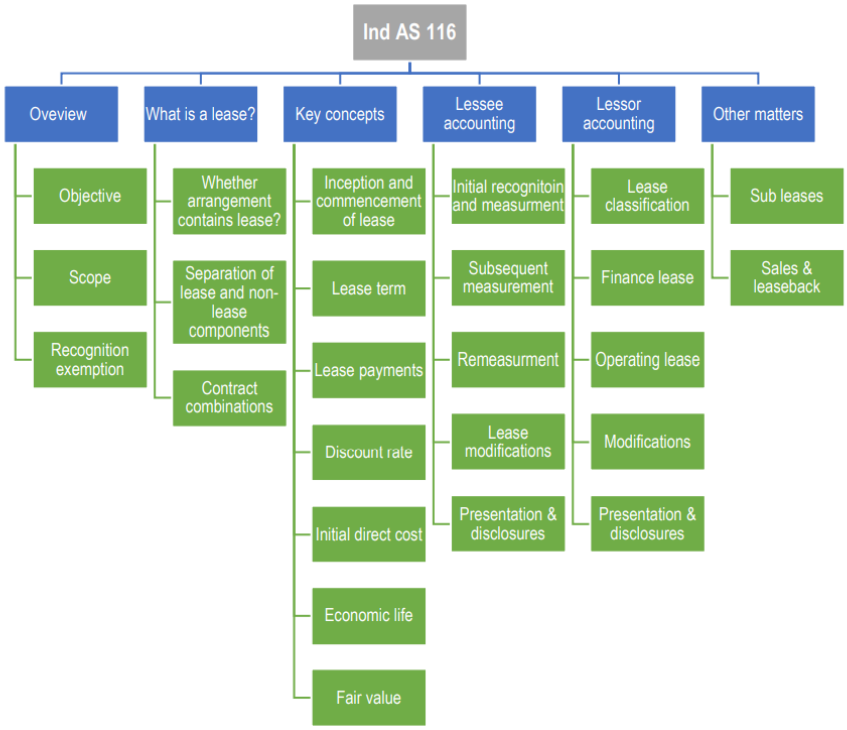
What has changed and why?

- Accounting for lessee has changed significantly
- Moving off-balance sheet financing to on-balance sheet for lessee.
- Lessee will capitalize all the leases except for short term and low value leases.
- No substantial change in accounting for lessor, disclosures have been enhanced

To bring transparency in financial reporting. This new standard will lead to a consistent, comparable and understandable financial information across industries.

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Agenda



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Change in definition of Leases

- Ind AS 17 vs Ind AS 116
- Added the concept of control along-with additional guidance
- Practical expedient given that contracts qualifying as lease under Ind AS 17 will be treated as leases under Ind AS 116, reassessment on date of transition not required

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Change in Balance Sheet of Lessees

	Ind AS 17		Ind AS 116
	Finance Lease	Operating Lease	All Leases
Assets		---	
Liabilities	xxx	---	xxx
Off-Balance Sheet	---	xxx 	---

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Change in Statement of Profit and loss of Lessees

	Ind AS 17		Ind AS 116
	Finance Lease	Operating Lease	All Leases
Revenue	xxx	xxx	xxx
Operating costs (Other than depreciation)	---	(xxx)	---
EBITDA	xxx	xxx	xxx
Depreciation and Amortization	(xxx)	---	(xxx)
Operating Profit	xxx	xxx	xxx
Finance costs	(xxx)	---	(xxx)
PBT	xxx	xxx	xxx

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Change in Statement of Cash Flows of Lessees

	Ind AS 17		Ind AS 116
	Finance Lease	Operating Lease	All Leases
Cash *outflows* from Operating activities	xxx	xxx	xxx
Cash *outflows* from Financing activities	xxx	---	xxx

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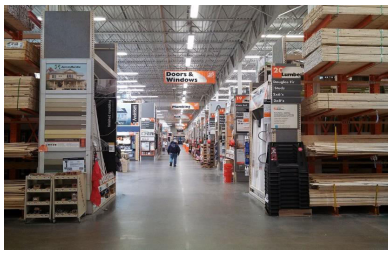
Highly Impacted Industries



Airlines



Oil and Gas



Retailers



Telecommunication



Information Technology

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Scope of Ind AS 116:

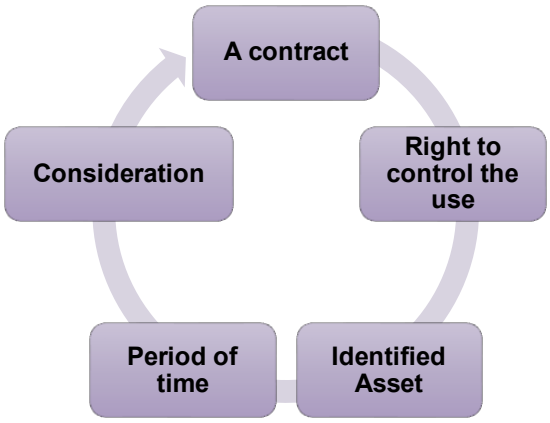
Ind AS 116 shall be applied to ALL LEASES, including leases of Right-of-Use (ROU) assets in a sub-lease, **EXCEPT** for:

Sr. No.	Particulars	Reason
1	Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	Within the scope of Ind AS 106 *'Exploration for and Evaluation of Mineral Resources'*
2	Leases of biological assets held by a lessee	Within the scope of Ind AS 41 *'Agriculture'*
3	Service concession arrangements	Within the scope of Appendix D of Ind AS 115 *'Revenue from Contracts with Customers'*
4	Licences of intellectual property granted by a lessor	Within the scope of Ind AS 115 *'Revenue from Contracts with Customers'*
5#	Rights held by a lessee under licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights	Within the scope of Ind AS 38 *'Intangible Assets'*

#A lessee may, but is not required to, apply Ind AS 116 to leases of intangible assets other than those described herein.

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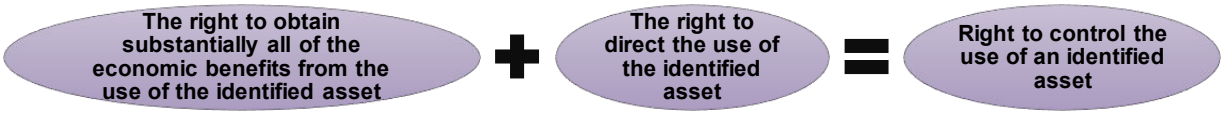
Identify a lease:



- Lease is a contract, or part of a contract, that conveys **the right to control the use of an identified asset** for a period of time in exchange for consideration.
- Underlying asset is an asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

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Right to control the use of an asset:



- These rights should remain **"throughout the period of use"**, if the customer has the right only for a portion of the term, then the contract contains lease for that limited term only.
- **Economic benefits:** Use, Hold or Sub lease the asset.
- **Benefits** = Primary output + By-products + Any other benefits
- A customer has **the right to direct** the use of the identified asset, if he either:
  - ✓ *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** in that manner throughout the period of use and the supplier does not have any right to change the **operating instructions**, or*
  - ✓ *Has **designed** the asset in a manner that predetermines how and for what purpose the asset will be used throughout the period of use.*
- The supplier may have **Protective Rights** which typically define the scope of the customer's right to use but does not prevent him from having right to control the use of the asset.

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Identified Asset:



- ***Exception:*** **If the supplier has a substantive right to substitute the asset throughout the period of use**
- The rights are substantive only if **BOTH** the following conditions are fulfilled:
  - ✓ *He has the practical ability to substitute the alternative assets throughout the period of use, and*
  - ✓ *He would economically be benefitted from doing so.*

If his rights/obligation to substitute becomes exercisable only on occurrence or non-occurrence of an event, then his rights are not substantive.

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Inception date of lease

Inception date is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
On this date, entities will:

- ✓ Identify a lease
- ✓ Lessor will classify the lease into finance or operating lease

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Commencement date of lease

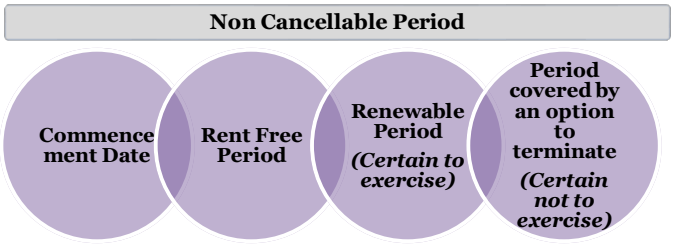
The date on which a lessor makes an underlying asset available for use by a lessee.
On this date, entities will:

- ✓ Determine the lease term
- ✓ Initially recognise the lease

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Lease term:

- The **non-cancellable period** of a lease which **includes** the period beginning from **the commencement** of lease and includes the **rent-free period** provided by the lessor to the lessee, together with both:
  - *Periods covered by an option to **extend** the lease if the lessee is **reasonably certain to exercise** that option; and*
  - *Periods covered by an option to **terminate** the lease if the lessee is **reasonably certain not to exercise** that option.*



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Case Study

Illustration 16 - Determining the lease term

Scenario A:

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity ABC is reasonably certain to exercise the renewal option. What is the lease term?

Scenario B:

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property. What is the lease term?

Scenario C:

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years. What is the lease term?

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Solution:

Scenario A:

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since it is mentioned that Entity ABC is not reasonably certain to exercise the option.

Scenario B:

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

Scenario C:

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

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Lease term: Termination clause

- If **both the parties have a right to terminate** the lease without any major penalty, the term ends there and the contract remains no longer enforceable.
- If **only the lessee has an option** to terminate the contract, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term.
- If **only the lessor has this right**, then the non-cancellable period includes the term covered by the option to terminate.

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Case Study

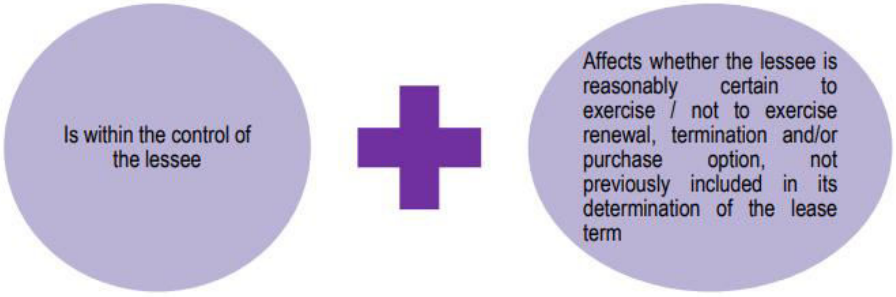
Suppose the term of a contract is 10 years and the non-cancellable / lock-in period is 6 years. The lease term shall be as follows:

If the termination option is with 'Lessor'	If the termination option is with 'Lessee'	If the termination option is with 'Both' (i.e., any party can terminate)
The lease term shall be **10 years**. *Because even after 6th year, the lessee would be contractually bound until 10th Year i.e. lessee cannot refuse to make the payment till the expiry of the contract and also, has the right to use the asset until 10th year, unless lessor terminates the contract.*	The lease term shall be **10 years** assuming reasonable certainty. *Because after the expiry of 6th year, though the lessee is not contractually bound till 10th year, i.e., the lessee can refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate. Hence, though there is no enforceable obligation from lessee's point of view beyond 6th year but, basis the said assumption, the lease term shall be 10 years.*	The lease term shall be **6 years**. *Because after 6th year, either party can terminate the contract without the consent of the other party and hence, the contract is not enforceable after 6th year ONLY in case there is insignificant penalty for termination.*

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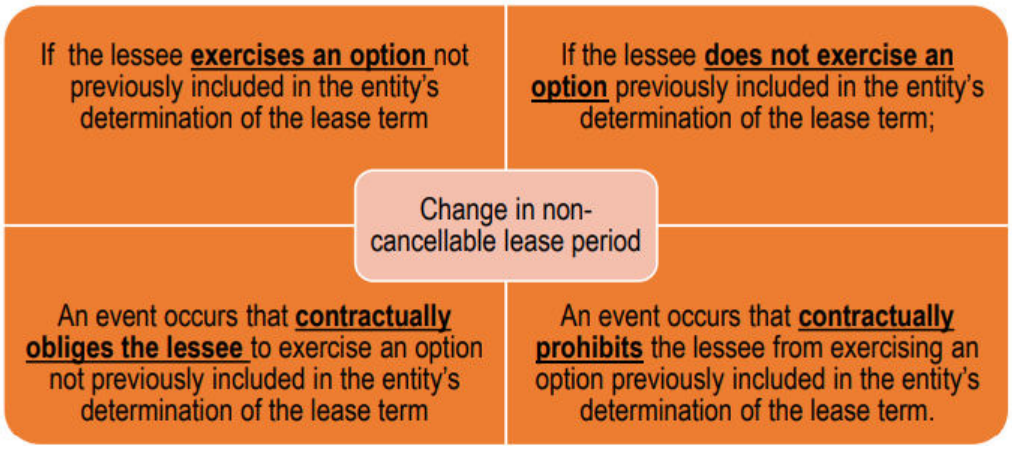
Reassessment of lease term

After the lease commencement, Ind AS 116 requires lessees to monitor leases for **significant changes** that could trigger a change in the lease term. Lessees are required to **reassess** the lease term upon the occurrence of either a **significant event *OR*** a **significant change** in the circumstances that:



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Revision of lease term



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Case Study

Illustration 17 - Re-assessment of exercise of lease extension option

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased. Is Retailer M required to reassess the lease term in this case?

Solution:

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew / extend the lease. In the given case, the Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess the lease term at the end of third year.

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Illustration 18 - Re-assessment of non-cancellable period of lease

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N has determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country. Will the lease term be reassessed in this case?

Solution:

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

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Future lease payments

Future lease payments for the lessor

Future lease payments for the lessee

Fixed payments (including in-substance fixed payments)**, *less* any lease incentives	Variable lease payments that depend on an index or a rate, measured using a prevailing rate at measurement date**	Exercise price of a purchase option	Penalties for terminating the lease	Residual value guarantees by the lessee	Residual value guaranteed to the lessor by a third party related/unrelated to the lessee

****Variable lease payments that do not depend on any index or rate are not in substance, fixed, and hence are not included in lease payments, they are charged to P&L as and when occurred.**

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Illustration 19 - Determining the fixed payments

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 200,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 170,000 for rent and ₹ 30,000 for real estate taxes.

What are the fixed lease payments for purposes of classifying the lease?

Solution:

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

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Illustration 21 - In-substance fixed lease payment

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental rate on each anniversary of the lease commencement date. What are the lease payments for purposes of measuring lease liability?

Solution:

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

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Case Study

Illustration 23 - Variable lease payments that depend on an index or rate

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108. What should be included in lease payments?

Solution:

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108).

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Interest rate:

Interest Rate Implicit in the lease is the rate at which*

** If that rate cannot be readily determined, the lessee shall use the **lessee's incremental borrowing rate**.*

(Net Investment in lease): **PV of lease payments accruing to the lessor** **+** **PV of Unguaranteed Residual Value**	**Fair Value of the underlying asset** **+** **Initial Direct cost to the lessor (not being manufacturer/dealer lessor)**

Net Investment = PV of Lease payments accruing to lessor + PV of Unguaranteed Residual Value

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Initial Direct Cost

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

1. Commission (including to employees acting as selling agents) **2. Legal fees** **3. Lease document preparation costs** **4. Payments to existing tenants to move out** **5. Consideration for a guarantee to an unrelated third party for residual value.**	**1. Employee Salaries** **2. Legal fees for services rendered before the execution of the lease** **3. Negotiating lease terms and conditions** **4. Advertising** **5. Depreciation and amortisation**

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Treatment in the books of lessee:

Initial Recognition:



ROU Asset	Dr.	Sum total of all below
Lease Liability	Cr.	PV of future lease payments to lessee using interest rate implicit in lease
Lessor/Supplier	Cr.	Any lease payment made on or before the commencement date (less lease incentives received)
Bank/Creditor	Cr.	Initial Direct Costs incurred by lessee
Provision for dismantling/removing the underlying cost	Cr.	Estimate of costs to be recognized only when lessee incurs an obligation for these costs (Ind AS 37)

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Exemption to lessee:

A lessee can opt for exemption from all the above treatment for a class of underlying assets to which the right of use asset belongs and recognize the lease payments of SLM basis over the period of use or other systematic basis.

Short Term Leases

Low Value Leases

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Short Term leases

- Lease term of 12 months or less.
- A lease that contains a purchase option is not a short-term lease.
- The election shall be made by class of underlying asset to which the right of use relates.

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Case Study

Illustration 1 - Short-term lease

Scenario A:

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. Whether the lessee can take a short-term exemption in accordance with Ind AS 116?

Scenario B:

Assume the same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain. Will your answer be different in this case?

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Solution

Scenario A:

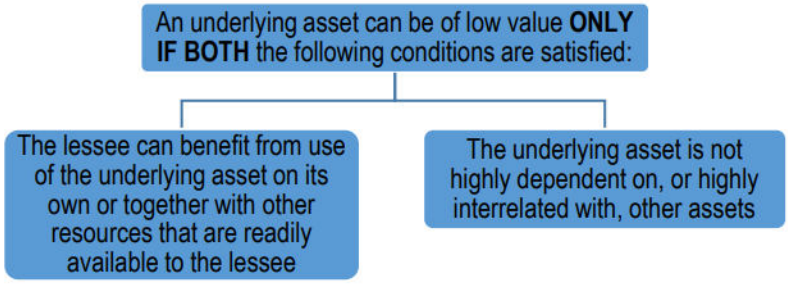
As the lessee is reasonably certain to exercise the extension option (Refer section 3.2 lease term), the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

Scenario B:

In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis.

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Low Value Leases



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

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Low Value Leases

Value of an underlying asset to be assessed based on the value of the asset when it is new, regardless of the age of the asset being leased *

Leases of low-value assets are exempted regardless of whether those leases are material to the lessee

Examples of low-value underlying assets can include:

- tablet
- personal computers,
- small items of office furniture
- telephones

The assessment performed on an absolute basis. It is not affected by the size, nature or circumstances of the lessee.

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Case Study

Illustration 27: Initial measurement of lease liability

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 100,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent.

Assume that the interest rate implicit in the lease is 5 per cent. How lease liability is initially measured?

Solution:

In the given case, the lease payments depend on a rate (i.e., LIBOR) and hence is included in measuring lease liability, As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent;

therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows

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Solution

Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,102
3	1,04,040	0.907	94,364
4	1,06,121	0.864	91,689
5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012
8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	77,083
			8,80,887

Therefore, the lease liability is initially measured at ₹ 8,80,887

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Case Study

Illustration 28: Measuring right-of-use asset

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on January 1, 2016:

- *The lease commencement date is February 1, 2016.*
- *Entity Y must pay Entity Z the first monthly rental payment of ₹ 10,000 upon execution of the lease.*
- *Entity Z will pay Entity Y ₹ 50,000 cash incentive to enter into the lease payable upon lease execution.*

Entity Y incurred ₹ 1,000 of initial direct costs, which are payable on February 1, 2016. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹ 850,000.

How would Lessee Company measure and record this lease?

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Solution

Solution:

Entity Y would calculate the right-of-use asset as follows: ₹

Initial measurement of lease liability	**8,50,000**
Lease payments made to Entity Z at or before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	1,000
Initial measurement of right-of-use asset	**8,11,000**

*****

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Treatment in the books of lessee:

Subsequent Measurement:

- **ROU Asset:**
  - **Cost model** i.e. (Cost l*ess* Accumulated Dep *less* Accumulated Impairment) and adjusted for any remeasurement of lease liability.
    - Depreciation period= Useful life of the asset {if lessee intends to purchase it} or the earlier of useful life or period of use.
    - Dep on SLM basis.
    - Apply Ind AS 16.
  - **Revaluation model,** in case right of use asset belongs to the class of PPE to which lessee chooses to apply RV model under Ind AS 16

- **Lease liability:**
  - Increased by : Interest charge in P&L at rate used for discounting, on the balance of lease liability
  - Decreased by: Actual lease payments

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Treatment in the books of lessee:

Expense Recognition

Lessees recognise the following items in expense for leases:

- Depreciation of the ROU Asset
- Interest expense on the Lease Liability
- Variable lease payments that are not included in the lease liability (***for e.g.***, variable lease payments that do not depend on an index or rate)
- Impairment of the ROU Asset

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Case Study

Illustration 30 - Lessee Accounting

*Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the **end** of each year:*

₹ 20,000 in year one

₹ 30,000 in year two

₹ 50,000 in year three.

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC would account for the said lease under Ind AS 116?

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Solution

Solution:

At the commencement date, Entity ABC would initially recognise ROU Asset and the corresponding Lease Liability of ₹ **77,364** which is calculated as follows:

Year	Payments (Cash flows)	Discounting Factor @12%	Discounted Cash flows / Present Value
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916
3	50,000	0.7118	35,590
	1,00,000		**77,364**

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	Opening balance	Interest Expense	Payments	Closing balance
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	-

* Difference of ₹ 4 is due to approximation.

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Solution

ROU Asset (assuming no lease incentives, no initial direct costs, etc.):

Year	Opening balance	Depreciation	Closing balance
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

At lease commencement, Entity ABC would recognise the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset	Dr.	77,364	
To Lease Liability			77,364
To initially recognise the Lease Liability and the corresponding ROU Asset			

The following journal entries would be recorded in the first year:

Interest Expense	Dr.	9,284	
To Lease Liability			9,284
To record interest expense and accrete the lease liability using the effective interest method (₹ 77,364 x 12%)			

Depreciation Expense	Dr.	25,788	
To ROU Asset			25,788
To record interest expense and accrete the lease liability using the straight line method (₹ 77,364 / 3 years)			

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Solution

Lease Liability	Dr.	20,000	
To Cash / Bank			20,000
To record lease payment			

Following is the summary of the said lease contract's accounting (assuming no changes due to reassessment):

Particulars	*Initially*	*Year 1*	*Year 2*	*Year 3*
Cash lease payments		20,000	30,000	50,000
Lease Expense Recognised:				
Interest Expense		9,284	7,998	5,354
Depreciation Expense		25,788	25,788	25,788
Total Periodic Expense		35,072	33,786	31,142
Balance Sheet:				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

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Case Study

Illustration 31 - Subsequent measurement using cost model

Company EFG enters into a property lease with Entity H. The initial term of the lease is 10 years with a 5- year renewal option. The economic life of the property is 40 years and the fair value of the leased property is ₹ 50 Lacs. Company EFG has an option to purchase the property at the end of the lease term for ₹ 30 lacs. The first annual payment is ₹ 5 lacs with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of ₹ 2 lacs (payable at the beginning of year 2), which is to be used for normal tenant improvement.

Company EFG is reasonably certain to exercise that purchase option. How would EFG measure the right-of-use asset and lease liability over the lease term?

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Solution

Solution:

As per Ind AS 116, Company EFG would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (W.N. 1)	₹ 37,39,648
PV of purchase option at end of lease term (W.N. 2)	₹ 12,60,000
Total lease liability	**₹ 49,99,648 or ₹ 50,00,000 (approx.)**

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Company EFG, lease payments made at or before the lease commencement date, or lease incentives received prior to the lease commencement date.

Entity EFG would record the following journal entry on the lease commencement date.

Right-of-use Asset	Dr.	₹ 50,00,000	
To Lease Liability			₹ 50,00,000
To record ROU asset and lease liability at the commencement date.			

Since the purchase option is reasonably certain to be exercised, EFG would amortize the right-of-use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be ₹ 1,25,000 (₹ 50,00,000 / 40 years)

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

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Solution

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year
	a	b= a-c	c = (d of pvs. Year)	d = [(e of pvs. year- a) x 9.04%]	e = (e of pvs. Year + d – a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213*	30,00,000
Year 10	30,00,000	27,50,787	2,49,213*	-	-
Total	**85,31,940**	**50,00,000**	**35,31,940**	**35,31,940**	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

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Solution

Working Notes

1. Calculating PV of lease payments, less lease incentive:

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A*B=C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555
Year 6	5,79,637	0.65	3,76,764
Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	3,00,098
Total			**37,39,648**

2. Calculating PV of purchase option at end of lease term:

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A*B=C)
Year 10	30,00,000	0.42	12,60,000
Total			**12,60,000**

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

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Separating components of a contract:

- An entity shall account for each lease components of a contract as a lease separately from non-lease components of the contract, unless the lessee may elect not to separate them and account for each component as a single lease component.



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Separating components of a contract:

- **Lessee**
  - *Shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.*
  - *As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.*
- **Lessor**
  - *Shall allocate the consideration in the contract applying Ind AS 115.*

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Case Study

Illustration 15 - Allocating contract consideration to lease and non-lease components – Lessees

A lessee enters into a lease of an equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	*₹ 80,000*
Maintenance	*₹ 10,000*
Total	***₹ 90,000***

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:

Lease	*₹ 85,000*
Maintenance	*₹ 15,000*
Total	***₹ 1,00,000***

In the given scenario, assuming lessee has not opted the practical expedient, how will the lessee allocate the consideration to lease and non-lease component?

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Solution:

The stand-alone price for the lease component represents 85% (i.e., ₹ 85,000 / ₹ 1,00,000) of total estimated stand-alone prices. The lessee allocates the consideration in the contract (i.e., ₹ 90,000), as follows:	
Lease	* ₹ 76,500
Maintenance	** ₹ 13,500
Total	**₹ 90,000**
** ₹ 90,000 x 85%* *** ₹ 90,000 x 15%*	

*****

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Lease modification: Meaning

- A change in the scope of a lease, **or**
- A change in the consideration for a lease,

that was not part of the original terms and conditions of the lease.

(for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

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Lease modification: Account for as a separate lease

- Increase in **scope** of the lease by adding the right to use one or more underlying assets, **and**
- Increase in **consideration** by an amount commensurate with the stand-alone price for the increase in scope

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Illustration 33 - Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

Solution:

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

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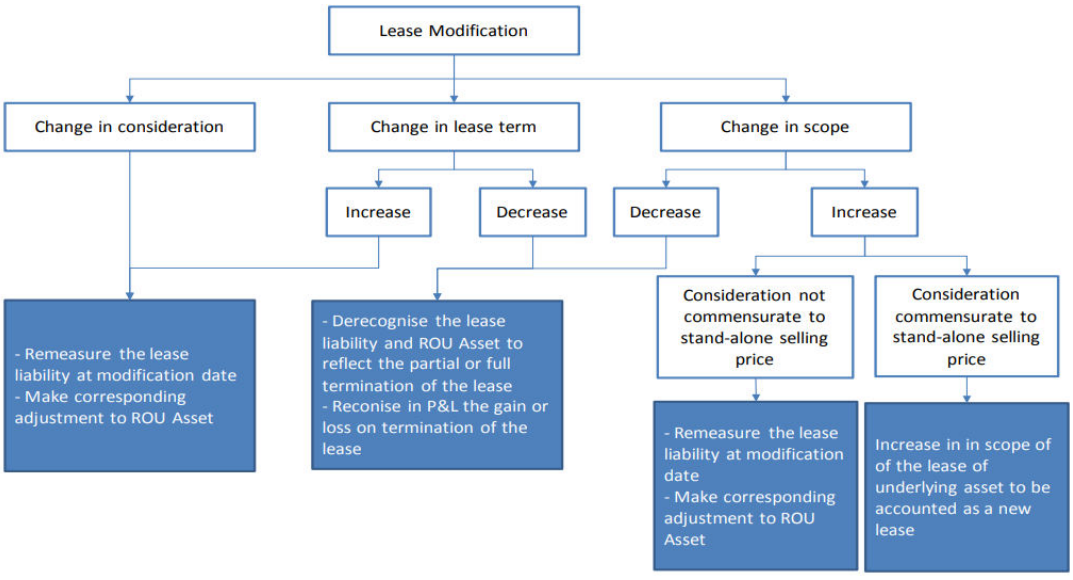
Lease modification: Not a separate lease

Decrease in scope	• Remeasure lease liability using revised discount rate * (1) • Decrease right-of-use asset by its relative scope compared to the original lease (2) • Difference between (1) and (2) recognised in P&L
All other lease modification	• Remeasure lease liability using revised discount rate* • Remeasure right-of-use asset by same amount

* The implicit rate in the lease is to be used. If it cannot be readily determined, the incremental rate of borrowing is to be used.

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Lease modification: Summary



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Illustration 34 - Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (i.e., ₹ 1,00,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7% p.a.

How should the said modification be accounted for?

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Solution

Solution:

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on:

(a) An eight-year remaining lease term

(b) Annual payments of ₹ 1,00,000 and

(c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

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Solution

Working Notes:

1. **Calculation of modified lease liability:**

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A*B=C)
7	100,000	0.935	93,500
8	100,000	0.873	87,300
9	100,000	0.816	81,600
10	100,000	0.763	76,300
11	100,000	0.713	71,300
12	100,000	0.666	66,600
13	100,000	0.623	62,300
14	100,000	0.582	58,200
Modified lease liability			**5,97,100**

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Solution

2. **Calculation of Lease liability as at commencement date:**

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			**7,35,900**

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Solution

3. **Calculation of Lease liability immediately before modification date:**

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090	25,265	100,000	3,46,355
	Lease liability as at modification date			3,46,355

4. **Adjustment to ROU asset:**

Modified Lease liability	5,97,100
Original Lease liability as at modification date	(3,46,355)
Adjustment to ROU asset	**2,50,745**

The ROU asset will be increased by ₹ 2,50,745 on the date of modification.

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Case Study

- **A enter into a 7 year lease for office space.**
- **Lease rent for the first 2 years is 30,000 per annum, payable at the beginning of the each year.**
- **After 2 years rental will be reassessed using a retail price index, which at present is 126. Revised Rental Rs. 32,000 per annum.**
- **Incremental cost of borrowing is 10%**

Solution:

On day 1 accounting entry will be:

ROU asset	160,658	
Lease liability {30,000*5.36 (annuity factor for 7 years)}		160,658

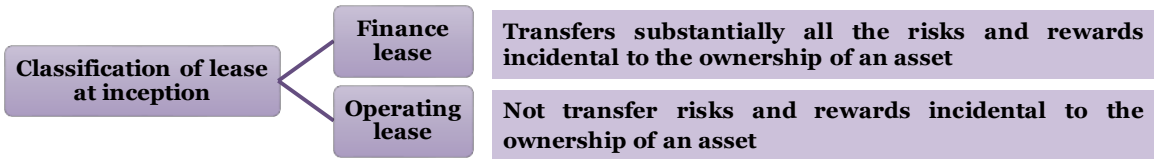
After 2 years the lease liability is 125,096 and ROU is 114,756

4.17 (4 years annuity factor @ 10%) *32,000	133,436
Lease liability (revised)	133,436

The lease liability is increased by 8,340 (1,33,436 – 1,25,096), the double entry is debit to ROU. Adjusted value of ROU 1,23,095 (114,756 + 8,340) will now be depreciated over the remaining 5 years.

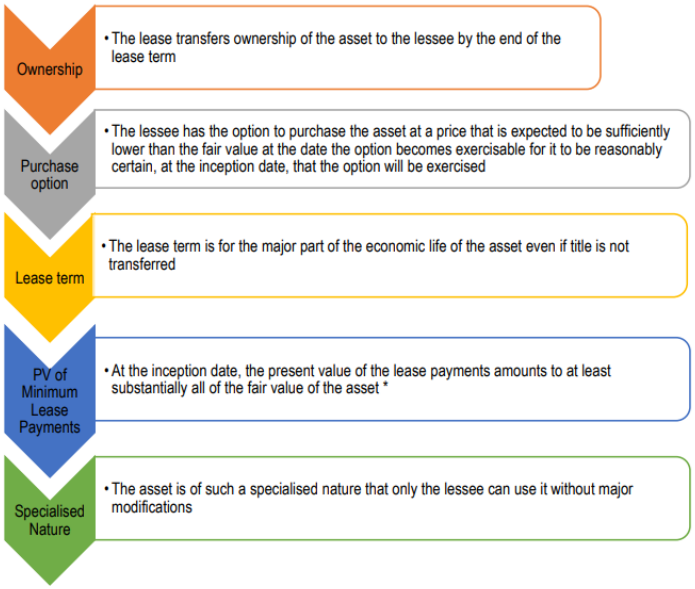
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Treatment in the books of lessor:



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Examples of Finance lease:



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Additional indicators of Finance lease:

Additionally, Ind AS 116 lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a **FINANCE LEASE**:

Loss on cancellation	• If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
Risk of fair value of the residual asset	• Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
Option to extend lease	• The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

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Treatment in the books of lessor:

Initial Recognition:

Finance Lease:

Finance Lease Receivable	Dr.	Net Investment
Underlying Asset	**Cr.**	**Carrying Amount**

(*Balancing figure: profit/loss)*

Operating Lease:

Any IDC is added to the carrying amount of underlying asset and amortized over the lease term on the same basis as lease income.

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Manufacturer or dealer lessor:

Initial Recognition:

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which Ind AS 115 applies.

Therefore, at lease commencement, a manufacturer or dealer lessor recognises the following:

The fair value of the underlying asset as revenue ***OR*** the present value of the lease payments discounted using a market rate of interest, whichever is **lower**.

The cost (or carrying amount) of the asset (less) the present value of the unguaranteed residual value, as cost of sale.

The selling profit or loss in accordance with the policy for outright sales.

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Treatment in the books of lessor:

Subsequent Measurement:

Finance lease receivable:

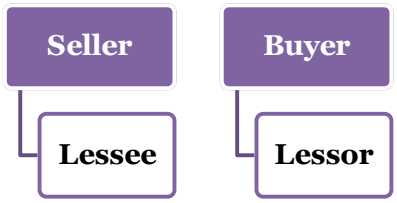
- Increased by : Interest income in P&L at rate used for discounting, on the balance of receivable
- Decreased by: Receipt of actual lease payments

Operating lease:

- Lease income recorded in P&L on SLM basis or another systematic basis *(SLM means total lease payments divided by lease term)*

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Sale and Leaseback Transaction



Assess if the transfer is accounted for as a sale under Ind AS 115:

- **If yes,** recognise gain/loss on rights transferred to the buyer and recognise a ROU asset for the portion of carrying amount pertaining to rights retained and a lease liability.
- **If no,** seller recognizes a financial liability for the amount received on transfer and buyer recognizes a financial asset

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If the Sale and Leaseback Transaction is accounted for as a sale as per Ind AS 115:

Steps to recognise Gain/loss on the rights transferred:

1. Calculate additional financing i.e. Sale price – Fair value
2. Allocate lease payments in the proportion of PV of lease payments and Additional financing
3. Calculate ROU asset in the books of seller-lessee i.e. (PV of annual lease payments – Additional financing) * Carrying value / Fair value
4. Compute gain/loss on sale of rights transferred on the asset (Sale price + ROU Asset – PV of annual lease payments – Carrying amount of the asset)

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Case Study

Illustration 42 - Sale and leaseback transaction

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of ₹ 30,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 15,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with annual payments of ₹ 2,00,000 payable at the end of each year.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in Ind AS 115 Revenue from Contracts with Customers.

The fair value of the building at the date of sale is ₹ 27,00,000. Initial direct costs, if any, are to be ignored. The interest rate implicit in the lease is 12% p.a., which is readily determinable by Seller-lessee.

Buyer-lessor classifies the lease of the building as an operating lease.

How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor?

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Solution

Considering facts of the case, Seller-lessee and buyer-lessor account for the transaction as a sale and leaseback.

Firstly, since the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer - lessor make adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of ₹ 3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price:	30,00,000
Less: Fair Value (at the date of sale):	(27,00,000)
Additional financing provided by Buyer-lessor to Seller-lessee	**3,00,000**

Next step would be to calculate the present value of the annual payments which amounts to ₹ 14,94,000 (calculated considering 20 payments of ₹ 2,00,000 each, discounted at 12% p.a.) of which ₹ 3,00,000 relates to the additional financing (as calculated above) and balance ₹ 11,94,000 relates to the lease — corresponding to 20 annual payments of ₹ 40,164 and ₹ 1,59,836, respectively (refer calculations below).

Proportion of annual lease payments:

Present value of lease payments (as calculated above)	(A)	14,94,000
Additional financing provided (as calculated above)	(B)	3,00,000
Relating to the Additional financing provided	(C) = (E x B / A)	40,160
Relating to the Lease	(D) = (E – C)	1,59,840
Annual payments (at the end of each year)	(E)	2,00,000

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Solution

Seller-Lessee:

At the commencement date, Seller-lessee measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, calculated as follows:

Carrying Amount	(A)	15,00,000
Fair Value (at the date of sale)	(B)	27,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
ROU Asset	**[(A / B) x C]**	**6,63,333**

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	Dr.	30,00,000	
ROU Asset	Dr.	6,63,333	
To Building			15,00,000
To Financial Liability			14,94,000
To Gain on rights transferred			6,69,333

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Solution

Buyer-Lessor:

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	Dr.	27,00,000	
Financial Asset (20 payments of ₹ 40,160 discounted @ 12% p.a.) (approx.)	Dr.	3,00,000	
To Cash			30,00,000

After the commencement date, Buyer-lessor accounts for the lease by treating ₹ 1,59,840 of the annual payments of ₹ 2,00,000 as lease payments. The remaining ₹ 40,160 of annual payments received from Seller-lessee are accounted for as:

(a) payments received to settle the financial asset of ₹ 3,00,000 ***AND***

(b) interest revenue.

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Sublease



1. If a lessee subleases the underlying asset or expects to do so, then the **head lease does not qualify as a low value lease** (for the purpose of exemption to lessee)
2. **Intermediate lessor shall classify the sublease into finance lease or operating lease** using following criteria:
   - If it's a short-term lease (12 months or less), he will classify it as an operating lease
   - Otherwise, he will classify the sub-lease with reference to the ROU asset and not the UNDERLYING asset, that means for a sub-lease to be classified as finance lease using useful life criteria the sub-lease term will be compared with the term of head lease i.e. ROU life and not the economic life of the asset.

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Case Study

Illustration 41 - Intermediate Lessor – Where the sublease is classified as a 'Operating Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the commencement of the head lease, the intermediate lessor subleases the 10,000 square metres of office space for two years to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the two-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as an operating lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease and since, it is not satisfied, classified the same as an operating lease).

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Lease of land and building:

- The classification into finance or operating lease will be done for land and building separately, as the land has an indefinite useful life it will be classified as an operating lease.
- The consideration will be apportioned between the two in proportion of their fair values at the inception date.
- If the amount of land is immaterial, lessor may consider it as a single unit and will classify the lease with regards to the economic life of building.

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THANK YOU

Presented by :
Alok Kumar Garg
CA, CS, Dip. IFRS (ACCA) UK, CIFRS (ICAI), B.Com (Hons.)

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