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LIVE COACHING CLASSES BOARD OF STUDIES (A), ICAI

CA FINAL PAPER 1: FINANCIAL REPORTING

TOPIC: IND AS 116 - LEASES

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Topics to be Covered

Particulars	Slides Reference		Slides Reference
What is a Lease?	3	Optional Exemption to Lessee	43-44
▪ Identified Asset	4-9	Accounting: Books of Lessee	45-52
▪ Right to Control Use	10-17	Accounting: Books of Lessor	53-56
Separation of Lease Components	18-19	Special Cases:	
Separation of Lease / Non-Lease Components	20-25	▪ Sub-Lease	57-60
Key Terms		▪ Sale and Leaseback	61-65
▪ Inception Date and Commencement Date	26	▪ Transition Approaches	66-67
▪ Lease Term	27-32	▪ Lease Modifications	68-73
▪ Leas Payments	33-41	▪ Remeasurement	74-75
▪ Initial Direct Cost and Discount Rate	42		



WHAT IS A LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease.

For the above purpose, a lease is defined as a contract, or part of a contract

- that conveys the **right to control** the use
- of an **identified asset**
- for a **period of time (lease term)**
- in **exchange for consideration (lease payments)**.



WHAT IS A LEASE: Identified Asset

An identified asset can be **explicitly specified** in a contract can be **implicit** in accordance with the terms of the contract. Moreover, an asset can be considered to be identified even if it is not yet manufactured, as it will be made available to the lessee in accordance with the contract.

Further, the identified asset should be such that **the lessor should not have a substantive right to substitute the asset throughout the period of use.**

Identified Asset (explicit / implicit / future assets)

The lessor does NOT have
substantive substitution rights

AND

The asset is **physically distinct**
The identified asset or part thereof should be independent



- In case of portion of assets, a capacity portion of an asset is an identified asset if it is physically distinct e.g. a floor in a building
- A capacity or other portion of an asset that is not physically distinct (e.g. capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.



WHAT IS A LEASE: Identified Asset

Substantive Substitution Rights

The lessor has the PRACTICAL ABILITY to substitute alternative assets throughout the period of use (e.g., lessee cannot prevent lessor from substituting an asset and alternative assets are readily available to lessor or could be sourced by lessor within a reasonable period of time).

AND

The lessor would BENEFIT ECONOMICALLY from the exercise of its right to substitute the asset [i.e., the economic benefits associated with substituting the asset are expected to exceed the costs (economic incentive or gain) associated with substituting the asset].

- The evaluation of existence of Substantive Substitution Rights (with lessor) should be done on the date of inception of the contract.
- Existence of rights which are merely protective in nature with the lessor after entering into a lease arrangement does not create substantive substitution right.
- Practical expedient provided by Ind AS 116: From a lessee's perspective, it involves judgment to decide whether the lessor holds substantive substitution rights and accordingly, as a result of the subjectivity involved in the assessment, Ind AS 116, in all cases, permits to let the lessee assume that the lessor's substitution rights are not substantive.



Page 7.100: Illustration 2 (Asset implicitly specified in a contract)

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but, Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Whether there is an identified asset?

Page 7.100: Illustration 3 (Asset implicitly specified in a contract)

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

Whether there is an identified asset?

ICAI Illustrations



Page 7.102-103: Illustration 4 (Substantive Substitution Rights)

Scenario A:

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Whether the substitution rights are substantive and whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A except that Server No. 10 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Whether the substitution rights are substantive and whether there is an identified asset?

ICAI Illustrations



Page 7.104: Illustration 5 (Identified Asset – Physically Distinct)

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Whether there is an identified asset?

Page 7.104: Illustration 6 (Identified Asset – Not Physically Distinct)

Scenario A:

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

ICAI Illustrations



Page 7.231: Question 1

A lessee enters into a ten-year contract with a lessor (freight carrier) to transport a specified quantity of goods. Lessor uses rail wagons of a particular specification and has a large pool of similar rail wagons that can be used to fulfil the requirements of the contract. The rail wagons and engines are stored at lessor's premises when they are not being used to transport goods. Costs associated with substituting the rail wagons are minimal for lessor.

Whether the lessor has substantive substitutions rights and whether the arrangement contains a lease?

ICAI Test Your Knowledge



WHAT IS A LEASE: Right to Control Use

Lessee has the right to control use of an identified asset for a period of time, if throughout the period of use, the lessee has

The right to obtain substantially all of the economic benefits from the use of the identified asset



These benefits would include benefits linked to usage either directly or indirectly by the lessee e.g.:

- Asset's primary output
- Any by-products or subsidies linked to usage (and not linked to ownership)
- Sub-leasing the asset (indirect benefit)

AND

The right to direct the use of the identified asset



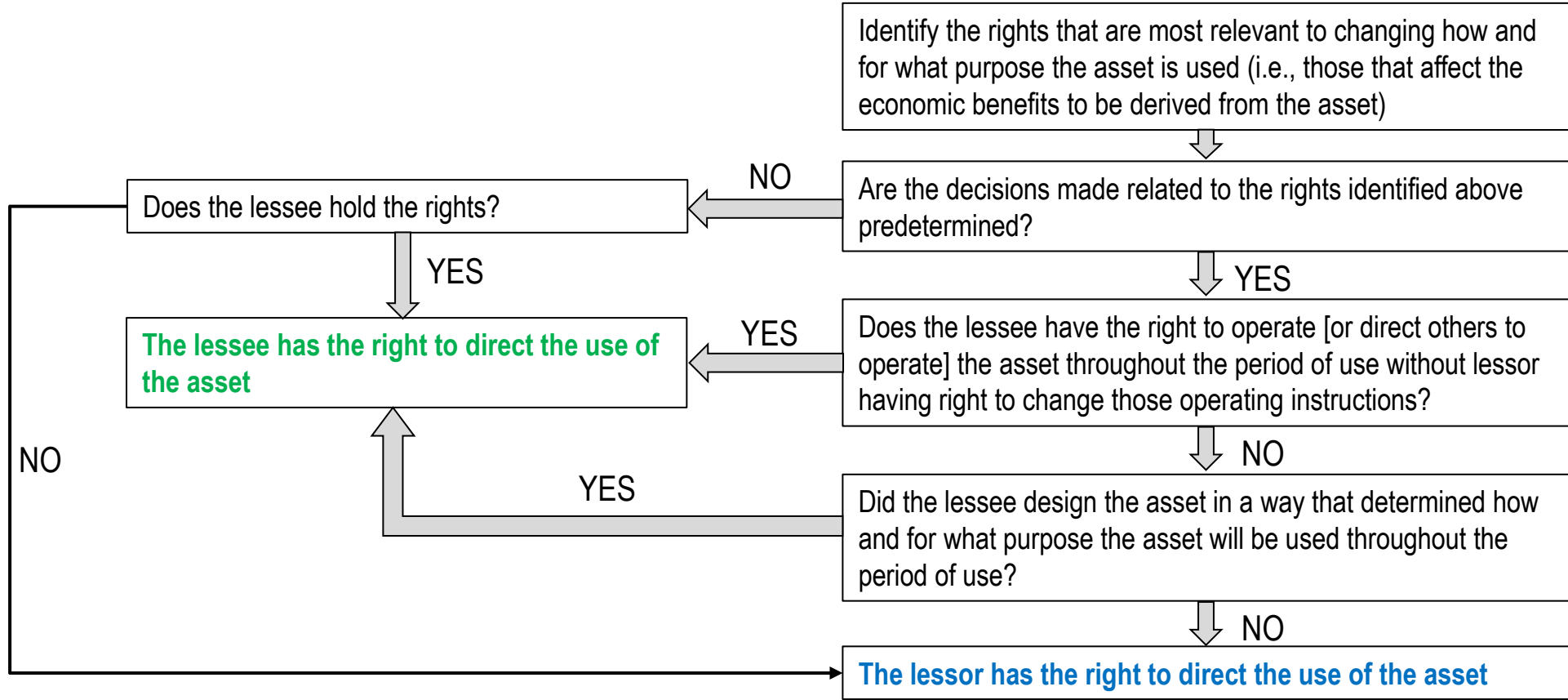
The lessee has the right to direct the use if substantial decisions linked to how and what purpose, where and when the asset will be used can be taken by the lessee



Refer chart on Slide 11



WHAT IS A LEASE: Right to Control Use





Page 7.105: Illustration 7 (Right to use for a portion of the term of contract)

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Which party has the right to control the use of the identified asset during the period of use?

Page 7.107: Illustration 8 (Right to obtain substantially all of the economic benefits)

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.

Who has the right to substantial benefits from the solar farm?

ICAI Illustrations



Page 7.110: Illustration 9 (Right to direct the use of an asset)

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down).

Under the contract:

- *Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).*
- *Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.*
- *Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.*

Whether Customer X has the right to direct the use of the vehicle throughout the period of lease?

ICAI Illustrations



Page 7.111: Illustration 10 (Right to direct the use of an asset)

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Which party has the right to control the use of the identified asset (i.e., equipment) during the period of use?

Page 7.111: Illustration 11 (Right to direct the use of an asset)

Entity L enters into a five—year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship, and is responsible for safe passage.

Who has the right to direct the use of the ship during the period of use?

ICAI Illustrations



Page 7.231: Question 2

Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M's energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced. Whether it can be established that M is having the right to control the use of identified asset?

Page 7.231: Question 3

A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. Customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship and is responsible for safe passage.

Does the customer have the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

ICAI Test Your Knowledge



May 2022: Question 8

Case I

Scenario 1: The 'last mile' is a dedicated cable that connects Entity Y's network with the end customer's device. The use of this cable is at the discretion of the customer. Entity Y decides the location of end points and has right to replace the lines (dedicated cable), however it is not practical to replace the lines, since replacement would require additional costs to be incurred without any corresponding benefit. Whether the arrangement would be within the scope of Ind AS 116?

Scenario 2: If it is practical for the Entity Y to replace the lines and Entity Y would benefit from this replacement, would the answer be different?

Case II

Customer X enters into a 10-year contract with a utility company, Entity Y, for the right to use three specified, physically distinct fibres within a larger cable connecting Mumbai to Delhi. Customer makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment. Entity Y owns extra fibres but can substitute those for Customer's fibres only for reasons of repairs, maintenance or malfunction. The useful life of the fibre is 15 years. Whether this arrangement is covered under Ind AS 116?

ICAI RTP



May 2022: Question 8 (continued)

Case III

Customer X enters into a 10-year contract with Entity Y for the right to use a specified amount of capacity within a cable connecting Mumbai to Delhi. The specified amount is equivalent to Customer X having the use of the full capacity of three fibre strands within the cable (the cable contains multiple fibres with similar capacities). Entity Y makes decisions about the transmission of data (i.e., Entity Y lights the fibres, makes decisions about which fibres are used to transmit Customer's traffic). The useful life of the fibre is 15 years. Whether this arrangement is covered under Ind AS 116?

ICAI RTP



SEPARATION OF LEASE COMPONENTS

It is possible that a single lease contract may have **multiple lease components** within it e.g. lease of a furnished flat would contain the lease of the property space as well the lease of the furniture and fixtures in the property.

In such cases, it is important to separate the Lease Components, as per the guidance given by Ind AS 116.

Separation of Lease Components

(e.g. separately identified assets such as furniture & fixtures, building / retail space, HVAC)

Separation of Lease Components would be done if the following conditions are satisfied

Lessee can benefit from the use of each asset / component in the lease

AND

The underlying asset is NOT highly interrelated or highly dependent on other assets in the contract

- Separation of lease components which fulfil the conditions above is mandatory as per Ind AS 116, and **there is NO PRACTICAL EXPEDIENT for non-separation.**
- Separation would be **based on the ratio of standalone price for each component** only. Accordingly, any breakup given / values assigned in the lease contract would be ignored. **Academically, if standalone prices / fair values are not given, assume the given breakup to be as per standalone prices only.**
- Where the standalone price is not available, the same can be estimated by determining fair value by maximizing the use of observable inputs.



Page 7.114: Illustration 12 (Identifying and separating lease components)

Scenario A:

A lessee enters a lease of an excavator and the related accessories (for e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine. How many lease and non-lease components are there?

Scenario B:

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (for e.g., to transport iron ores at another mine).

ICAI Illustrations



SEPARATION OF LEASE AND NON-LEASE COMPONENTS

- It is possible that a single lease contract may have **lease and non-lease components** within it e.g. lease of a flat with maintenance facilities or water and electricity charges / lease of car with chauffeur services etc.
- Such agreements are in substance: lease contracts + purchase of goods / services.
- Separation needs to be done between the lease and non-lease components. After separation, the lease component will be accounted for as per Ind AS 116, and the non-lease component will be accounted for based on the respective Ind AS to which they pertain, or if no Ind AS is applicable, in accordance with GAAP (generally involves expensing to P/L).
- Optional exemption of using a **PRACTICAL EXPEDIENT** is provided in Ind AS 116. **An entity, by way of an accounting policy choice, may choose not to separate the non-lease and lease components.** Where such an exemption is availed, then the entire contract consideration would be allocated the lease components i.e. **the lease components would, strictly speaking, be overstated.**

IMPORTANT ASPECT:

- Only those non-lease components which **provide benefit to the lessee are to be considered for the above purposes.** Where components such as property taxes, insurance, administrative charges are included in the lease contract which DO NOT provide any benefit to the lessee, the contracted amounts of such components would be included in the overall contract consideration and allocation to the lease components / lease and non-lease components depending on the PRACTICAL EXPEDIENT availed by the entity would be made based on the standalone prices / fair value of the lease and non-lease components.



Page 7.116: Illustration 13 (Identifying different components in contract)

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes single monthly rental payment and does not pay for the maintenance separately. The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

What are the units of account in the lease?

ICAI Illustrations



Page 7.118: Illustration 15 (Allocating contract consideration to lease and non-lease components)

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?

ICAI Illustrations



Page 7.117: Illustration 14 (Activities which are not components of a lease contract)

Scenario A:

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹ 10,000. The contract contains fixed annual payments as follows: ₹ 8,000 for rent, ₹ 1,500 for maintenance and ₹ 500 of administrative tasks. How the consideration would be allocated?

Scenario B:

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition. How the consideration would be allocated?

ICAI Illustrations



Page 7.231: Question 4

A Lessee enters into a ten-year lease contract with a Lessor to use an equipment. The contract includes maintenance services (as provided by lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 relate to maintenance services and ₹ 500 to insurance costs).

The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for a similar equipment because none is leased without related maintenance services provided by the lessor.

How would the Lessee allocate the consideration to the lease component?

ICAI Test Your Knowledge



November 2020: Question 17

Entity X (lessee) entered into a lease agreement ('lease agreement') with Entity Y (lessor) to lease an entire floor of a shopping mall for a period of 9 years. The annual lease rent of ₹ 70,000 is payable at year end. To carry out its operations smoothly, Entity X simultaneously entered into another agreement ('facilities agreement') with Entity Y for using certain other facilities owned by Entity Y such as passenger lifts, DG sets, power supply infrastructure, parking space etc., which are specifically mentioned in the agreement, for annual service charges amounting to ₹ 1,00,000. As per the agreement, the ownership of the facilities shall remain with Entity Y. Lessee's incremental borrowing rate is 10%.

The facilities agreement clearly specifies that it shall be co-existent and coterminous with 'lease agreement'. The facility agreement shall stand terminated automatically on termination or expiry of 'lease agreement'.

Entity X has assessed that the stand-alone price of 'lease agreement' is ₹ 1,20,000 per year and stand-alone price of the 'facilities agreement' is ₹ 80,000 per year. Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component (s) from lease component(s) and accordingly it separates non-lease components from lease components.

How will Entity X account for lease liability as at the commencement date?

ICAI RTP



KEY TERMS: INCEPTION DATE AND COMMENCEMENT DATE

INCEPTION DATE:

Earlier of (a) date of lease agreement, and (b) date of commitment by the parties to the contract to the principal terms.

The inception date is the date when an entity assesses whether a contract is or contains a lease or not.

For example:

Date of commitment to the principal: 1 April, 2021

Date of Lease Agreement: 15 June, 2021

Inception date will be earlier of the above, i.e. 1 April, 2021

COMMENCEMENT DATE:

This refers to the **date when the underlying asset is made available for use to the lessee.**

The accounting for the ROU Asset / Lease Liability will start from this date.

Continuing the above example:

Date of making the underlying asset available for use to lessee: 1 July, 2021

Date of commencement of lease payments: 1 August, 2021

Commencement date will be 1 July, 2021; date of lease payment made is not relevant for the initial recognition of the ROU Asset / Lease Liability



KEY TERMS: LEASE TERM

LEASE TERM:

It refers to the:

Non-cancellable period (+) Renewal option (if reasonably certain that the renewal option will be exercised) (+) Periods covered where there is an option to terminate (if reasonably certain that the termination option will NOT be exercised)

The assessment of the additional / deductible period (renewal / termination) is based on an evaluation of the factors that give rise to an economic incentive for the lessee to continue e.g.

- location of the asset in a premium area;
- incurring significant leasehold improvements; or
- a rent significantly lower than the market rent in the optional period



Page 7.124: 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?

ICAI Illustrations



Page 7.232: Question 5

A Lessee enters into a non-cancellable lease contract with a Lessor to lease a building. Initially, the lease is for five years, and the lessee has the option to extend the lease by another five years at the same rental.

To determine the lease term, the lessee considers the following factors:

- Market rentals for a comparable building in the same area are expected to increase by 10% over the ten-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
- The lessee intends to stay in business in the same area for at least 20 years.
- The location of the building is ideal for relationships with suppliers and customers.

What should be the lease term for lease accounting under Ind AS 116?

ICAI Test Your Knowledge



Page 7.232: Question 6

A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

To determine the lease term, the lessee considers the following factors:

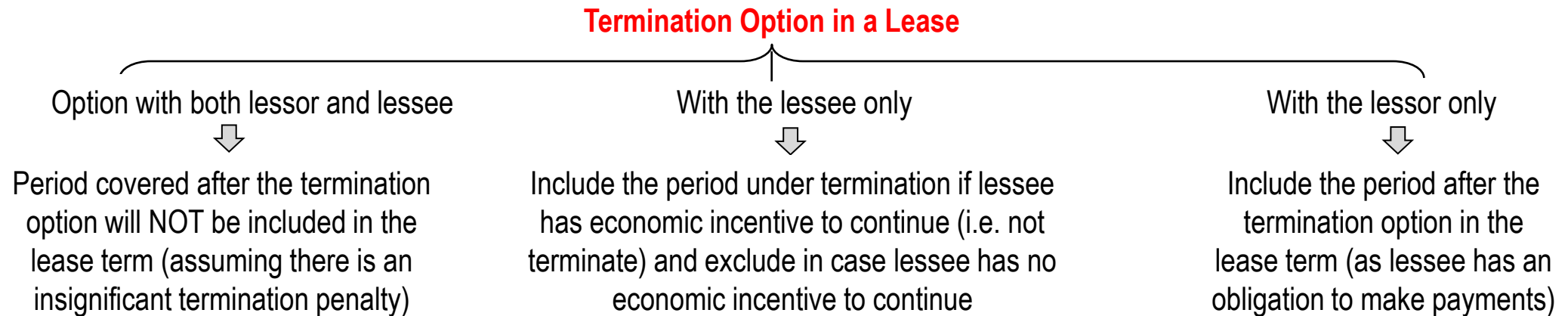
- The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.
- The cost to install the machine in lessee's manufacturing facility is significant.
- The non-cancellable term of lessee's manufacturing facility lease ends in 19 years, and the lessee has an option to renew that lease for another twelve years.
- Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
- The total remaining life of the machine is 30 years.

What should be the lease term for lease accounting under Ind AS 116?

ICAI Test Your Knowledge



KEY TERMS: LEASE TERM (continued)



Can the LEASE TERM be reassessed subsequently?

An entity must reassess the lease term upon occurrence of a significant event or a significant change in circumstances e.g.

- Subsequent construction of significant leasehold improvements by the lessee;
- Business decisions taken by the lessee that have a direct impact on the usage of the underlying asset such as tie-ups or subleasing.



Page 7.128: 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?

Page 7.128-129: 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?

ICAI Illustrations



KEY TERMS: LEASE PAYMENTS

LEASE PAYMENTS:

Lease Payments are payments made by the lessee to the lessor in exchange for the right to use an underlying asset during the lease term. They comprise the following (where applicable):

Particulars		Slide Ref.	₹	₹
(a)	Fixed Payments (including in substance fixed payments)	34 (Pt. 1 & 2)	xxx	
	Less: Lease Incentives (after commencement date)	34 (Pt. 3)	<u>(xx)</u>	xxx
(b)	Variable Lease Payments	34-35 (Pt. 4)		xxx
(c)	Exercise Price of a Purchase Option if lessee is reasonably certain to exercise the option	36 (Pt. 5)		xxx
(d)	Payments of penalties for terminating the lease if it is reasonably certain that termination option will be exercised	NA		xxx
(e)	Payments expected to be made under residual value guarantee by the lessee	36 (Pt. 6)		<u>xxx</u>
TOTAL LEASE PAYMENTS (for the purpose of Lease Liability calculation)				<u>xxx</u>

Exclusions of Payments while calculating Lease Liability:

(i) Payments allocable to the non-lease components (assuming practical expedient is not exercised), and (ii) variable payments that DO NOT depend on Index or Rate.



KEY TERMS: LEASE PAYMENTS (continued)

Points to Note:

- 1. Fixed Payments:** refer to **determinable amounts to be paid**, which may / may not be the same (equal) in each year e.g. payments of ₹ 1,00,000, ₹ 1,20,000, ₹ 1,30,000 and ₹ 1,40,000 per annum over 4 years are treated as fixed payments, though the amounts vary each year. Another example of fixed payments could be a clause stated in the lease agreement mandating an increase of lease rent every year by 10%.
- 2. In-substance Fixed Payments:** refer to payments which appear to be variable in form, but in substance **contain an unavoidable payment**. E.g. if lessee has to make payment out of a set of realistic possible payments, then the lower amount, if determinable, is in substance, a fixed payment.
- 3. Lease Incentives:** refer to payments made by the lessor to the lessee e.g. a signing bonus. These payments reduce the cash outflow for the lessee and hence should be deducted from the lease payments.
- 4. Variable Payments:** It refers to payments which are not determinable (as in the case of fixed payments above):

Linked to Index or Rate



An index (e.g. Consumer Price Index) or a rate (e.g. LIBOR / MIBOR) assist to reflect the change in the rentals based on passage of time



Not linked to Index or Rate



e.g. Payments computed as per performance-based measures such as a % of Revenue or based on number of units produced





KEY TERMS: LEASE PAYMENTS (continued)

Linked to Index or Rate

INCLUDE these variable lease payments based on the rate / index prevailing on the date of commencement at initial recognition



These payments will be remeasured when is a change in cash flows

Not linked to Index or Rate

NOT INCLUDED in the ROU Asset / Lease Liability calculation, as passage of time is not reflected in the determination of such payments



Expenses recognized in the P/L as and when they are incurred



Expenses recognized in the P/L as and when they are incurred



Where the variability surrounding the payments is resolved during the lease term and the payments become fixed (determinable) thereafter, then these fixed payments should be considered in the ROU Asset / Lease Liability measurement



KEY TERMS: LEASE PAYMENTS (continued)

Points to Note:

- 5. Lease with Purchase Option:** refers to **option given to lessee** to purchase the asset (though purchase is NOT mandatory, unlike in case of Hire Purchase, where purchase was mandatory). Entity needs to evaluate whether there is significant economic incentive (e.g. purchase price under option < fair value) in exercising the purchase option, and if that be the case, then take the same into account while calculating lease liability.

Impact of Purchase Option: ROU Asset which would normally be depreciated over the lease term, would now be depreciated over the entire economic life of the asset in case the Purchase option is likely to be exercised.

Reassessment of the Purchase Option can be done subsequently.

- 6. Residual Value Guarantees:** refer to payments made by the lessee to the lessor under a guarantee that the underlying asset would be worth a specified amount at the end of the lease term. At the end of the lease term, a fair valuation of the underlying asset would be carried out, and if the expected residual value < guaranteed amount, then the payment to be made by the lessee would be **(Guarantee Amount – Expected Residual Value)**. Such payment would be included in the lease payments by the lessee, as well as in the lease receipts by the lessor.

In some cases, the residual value guarantee is given by an independent third party and NOT the lessee. In such cases, such guarantee payments would NOT be included by the lessee in lease payments, but would be factored in the lease receipts by the lessor.



Page 7.130: 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?

Page 7.131: Illustration 20 (In-substance fixed lease payments)

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

- *If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.*
- *If Q does not use the machinery within a given month, then an amount of 1,000 accrues for that month.*

What is considered as lease payment in this case?

ICAI Illustrations



Page 7.131: Illustration 21 (In-substance fixed lease payments)

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?

Page 7.131: Illustration 22 (In-substance fixed lease payments)

Company N leases a production line. The lease payments depend on the number of operating hours of the production line – i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours.

Page 7.132-133: 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?

ICAI Illustrations



Page 7.133: Illustration 24 (In-substance fixed lease payments)

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract. Whether these payments affect the calculation of lease liability and ROU Asset? How does Entity XYZ and Customer ABC would allocate these lease payments?

ICAI Illustrations



Page 7.134: Illustration 25 (Variable lease payments)

Entity A enters into a five-year lease of an office building. The lease payments are ₹ 5,00,000 per year and the contract includes an additional water charge calculated as ₹ 0.50 per litre consumed. Payments are due at the end of year. Entity A elects to apply the practical expedient to combine lease and non-lease components.

Page 7.135: Illustration 26 (Residual value guarantee included in lease payments)

An entity (a lessee) enters into a lease and guarantees that the lessor will realise ₹ 20,000 from selling the asset to another party at the end of the lease. At lease commencement, based on the lessee's estimate of the residual value of the underlying asset, the lessee determines that it expects that it will owe ₹ 8,000 at the end of the lease. Whether the lessee should include the said payment of ₹ 8,000 as a lease payment?

ICAI Illustrations



Page 7.232: Question 7

A Company leases a manufacturing facility. The lease payments depend on the number of operating hours of the manufacturing facility, i.e., the lessee has to pay ₹ 2,000 per hour of use. The annual minimum payment is ₹ 2,00,00,000. The expected usage per year is 20,000 hours.

Whether the said payments be included in the calculation of lease liability under Ind AS 116?

ICAI Test Your Knowledge



KEY TERMS: INITIAL DIRECT COST AND DISCOUNT RATE

INITIAL DIRECT COST (IDC):

IDC refer to the **incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.**

E.g. commission to real estate broker, legal fees for execution of lease, payments to existing tenants to move out etc.

Alternatively, items such as travelling expenses, advertising, legal fees for services rendered before execution of lease etc., which are **regardless of whether the lease is entered into or not**, are excluded from the purview of IDC

DISCOUNT RATE:

This is the rate used to find the present value of lease payments. The discount rate should be:

- (i) Interest rate implicit in the lease (i.e. lessor's IRR)
- (ii) If the above is not determinable, then the lessee's incremental borrowing rate.

Lessor's IRR can be calculated as the rate at which:

Present Value of Cash Outflows of Lessor (Fair Value + IDC of lessor) = Present Value of Cash Inflows [Lease Payments + Unguaranteed Residual Value (UGRV)]

UGRV = Expected Residual Value – Guaranteed Residual Value (if positive)



RECOGNITION: OPTIONAL EXEMPTIONS (FOR LESSEE)

- The most radical change in accounting for lease arrangements introduced by Ind AS 116 was the recognition of an ROU Asset and a Lease Liability by the lessee, in place of the Finance Lease and Operating Lease Accounting models under the erstwhile Ind AS 17 and AS 19 regimes.
- However, given the complexity involved in recognition of ROU Asset and Lease Liability such as determination of discount rate, determination of whether every contract is or contains a lease etc., Ind AS 116 has given an 'optional' exemption from applying the above treatment. Instead, **if a lessee chooses to avail the exemption, the lease payments would be directly recognized as rental expenses in the P/L either on straight-line basis or any other systematic basis if available** (similar to the treatment as an operating lease arrangement under Ind AS 17 / AS 19). **The exemption is to be availed at the commencement date.**

Short-term Leases

A lease with a lease term < 12 months from the commencement date and no purchase option



Choice to be exercised for class of underlying assets (and not lease by lease) e.g. recognition exemption can be availed for furniture, though continuing to apply ROU asset recognition for building with lease term < 12 months

Lease of low-value items

Low value assets are not specifically defined. The following items CANNOT be treated as low-value items:

(a) Assets which are highly interrelated / highly interdependent with other assets e.g. tyre is highly interrelated with a car, but a laptop / mobile is generally independent

(b) Head Leases

The choice needs to be taken on a lease by lease basis (and not for an entire class)



Page 7.95: 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?

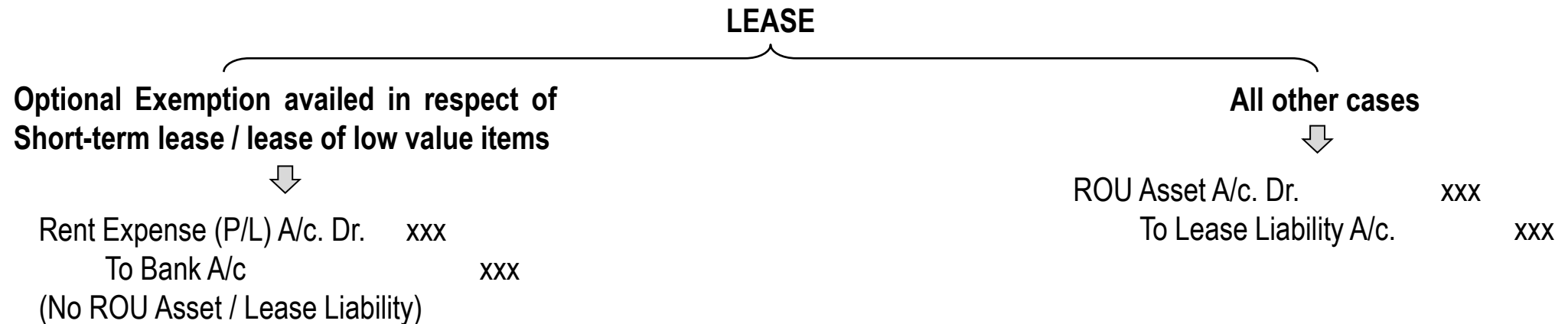
Scenario B:

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?

ICAI Illustrations



ACCOUNTING IN THE BOOKS OF LESSEE



Note 1: Measurement of Lease Liability:

Lease Liability is measured as the Present Value of all future lease payments (defined earlier) to be made during the lease term (defined earlier) discounted at the interest rate implicit in the lease.

Subsequently, the lease liability would change due to:

- (a) Interest
- (b) Lease Payments
- (c) Impact of re-assessment / lease modification

The subsequent accounting for lease liability would be similar to the accounting for financial liabilities on an amortized cost basis.



ACCOUNTING IN THE BOOKS OF LESSEE (continued)

Note 2: Measurement of ROU Asset:

Initial Measurement (at Cost):

Particulars		Credit / (Debit) to	₹
	Initial Lease Liability	Lease Liability	
Add:	Payments made before commencement date (between lessor-lessee)	Bank	xxx
Less:	Lease Incentives received before commencement date (between lessor-lessee)	(Bank)	xxx
Add:	Initial Direct Cost (IDC) incurred by lessee (between lessee-third party)	Bank	xxx
Add:	Present Value of Site Restoration / Decommissioning Obligations (between lessee-third party)	Provision	<u>xxx</u>
INITIAL COST (ROU ASSET)			<u>xx</u>
			<u>x</u>

ROU Asset A/c. Dr.	xxx
To Lease Liability A/c.	xxx
To Bank (net)	xxx
To Provision for Site Restoration	xxx



ACCOUNTING IN THE BOOKS OF LESSEE (continued)

Note 2: Measurement of ROU Asset:

Subsequent Measurement:

Unless given, it is assumed that cost model is applied as under:

Particulars		₹
	Initial Cost	
Less:	Accumulated Depreciation	xxx
Less:	Impairment	<u>xxx</u>
	Carrying Value	xxx
Add:	Adjustment for remeasurement of lease liability (due to reassessment / modification)	<u>xxx</u>
	ADJUSTED CARRYING VALUE	<u>xxx</u>

Depreciation of the ROU Asset will generally be over the lease term. However, in case there is a purchase option which is expected to be exercised by the lessee, then the asset would continue with the lessee for the entire useful life and hence in such cases, ROU Asset would be depreciation over the entire useful life.

The above treatment of depreciating the ROU Asset over the entire useful life would also apply for leases in perpetuity.



Page 7.141: 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?

Page 7.143: 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 1 January, 20X1:

- *The lease commencement date is 1 February 20X1.*
- *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 1 February 20X1. 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 ₹ 8,50,000.

How would Lessee Company measure and record this lease?

ICAI Illustrations



Page 7.144: Illustration 29 (Dismantling costs to be included in initial measurement of ROU Asset)

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 100,000 flight hours. At the end of the lease, company H must have a check performed (or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Page 7.147-148: 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 account for the said lease under Ind AS 116?

ICAI Illustrations



Page 7.149-150: 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 advance 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?

ICAI Illustrations



ACCOUNTING IN THE BOOKS OF LESSEE (continued)

Note 3: Leases denominated in Foreign Currency

Where the leases are denominated in foreign currency, the ROU Asset –being a non-monetary item –would appear at the historic rate. However, the lease liability which reflects a determinable amount of cash payments is a monetary item which will appear at the closing rate. Any foreign exchange gain/loss on account of restatement of lease liability would be taken to the P/L.



May 2021: Question 11 / TYK Q. 9

Entity X is an Indian entity whose functional currency is Indian Rupee. It has taken a plant on lease from Entity Y for 5 years to use in its manufacturing process for which it has to pay annual rentals in arrears of USD 10,000 every year. On the commencement date, exchange rate was USD = ₹ 68. The average rate for Year 1 was ₹ 69 and at the end of year 1, the exchange rate was ₹ 70. The incremental borrowing rate of Entity X on commencement of the lease for a USD borrowing was 5% p.a.

How will entity X measure the right of use (ROU) asset and lease liability initially and at the end of Year 1?

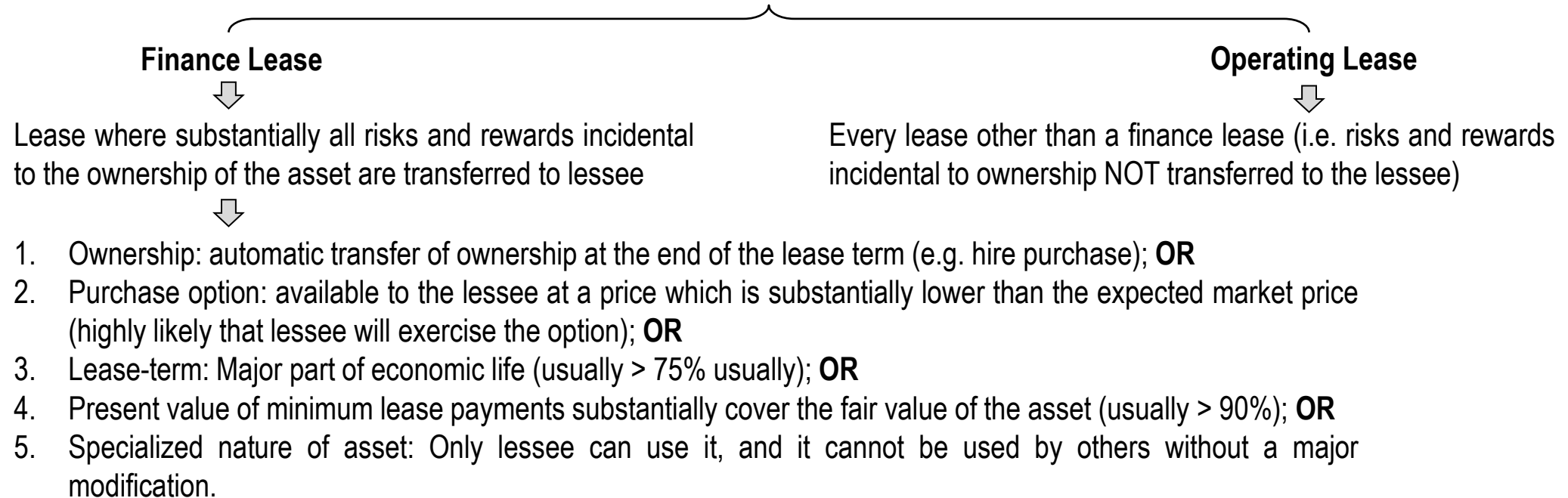
ICAI RTP



ACCOUNTING IN THE BOOKS OF LESSOR

The accounting for the lessor under Ind AS 116 is largely on the lines of Ind AS 17 / AS 19. At inception, the lessor needs to classify the lease as a finance lease or as an operating lease.

LEASE CLASSIFICATION





ACCOUNTING IN THE BOOKS OF LESSOR (continued)

Particulars	Finance Lease		Operating Lease	
INITIAL RECOGNITION	Lease Receivable A/c Dr.	xxx	No Entry	
	P/L A/c. (Loss)	xxx		
	To Asset A/c (WDV)	xxx		
	To P/L A/c. (Gain)	xxx		
SUBSEQUENT MEASUREMENT	No Depreciation		Depreciation A/c. (P/L) Dr.	xxx
			To Asset A/c.	xxx
	Bank A/c. Dr.	xxx	Bank A/c. Dr.	xxx
	To Finance Income	xxx	Deferred Rent A/c. Dr.	xxx
	To Lease Receivable A/c.	xxx	To Rent Income (P/L)	xxx

Note 1: The Lease Receivable should be recorded at the Net Investment in the Lease.

- Gross Investment in the Lease = Lease Payments + Unguaranteed Residual Value (UGRV)
- Net Investment in the Lease = Present Value of Lease Payments + Present Value of UGRV i.e. Present Value of Gross Investment in the Lease
- Unearned Finance Income = Gross Investment in the Lease (-) Net Investment in the Lease
- UGRV = Expected Residual Value (-) Guaranteed Residual Value



ACCOUNTING IN THE BOOKS OF LESSOR (continued)

Note 2: Straight-lining of Lease Rent in case of Operating Leases:

Lease Rent Income should be recognized on a straight-line basis, unless another systematic basis is more representative.

Note 3: Manufacturer / Dealer Lessor

In this case, record revenue based on lower of fair value of the asset or the present value of lease payments (excluding UGRV).

The COGS would be calculated as: Cost – Present Value of UGRV.

The difference will be shown as selling profit (Gross Profit). The presentation of profit on sale of inventory is generally presented by showing the Revenue and COGS separately, and hence the above figures need to be calculated.

Any initial direct cost incurred by a manufacturer / dealer lessor is to be expensed immediately to the P/L as it is attributable to sale (and not to the lease).



Page 7.179-180: Illustration 38 (Lessor accounting for a finance lease: dealer-lessor case)

A Dealer-Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- *Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year*
- *Lessor expects the residual value of the equipment to be ₹ 50,000 at the end of the 10-year lease term*
- *Lessee provides a residual value guarantee that protects Lessor from the first ₹ 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., ₹ 50,000)*
- *The equipment has an estimated remaining economic life of 15 years, a carrying amount of ₹ 1,00,000 and a fair value of ₹ 1,11,000*
- *The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset*
- *The interest rate implicit in the lease is 10.078%.*

How should the Lessor account for the same in its books of accounts?

ICAI Illustrations



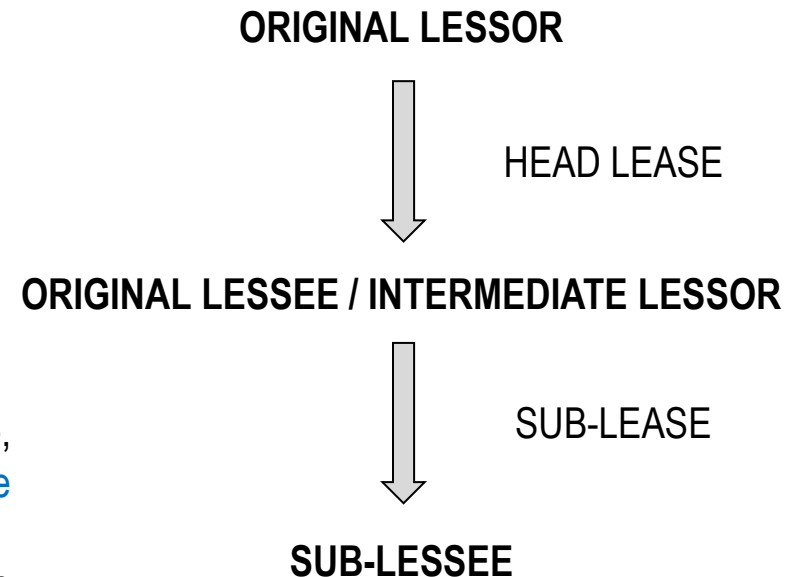
SPECIAL CASES: SUB-LEASE

What is a sub-lease?

A transaction in which an underlying asset is re-leased by a lessee to a third party.

Important Points:

1. To assess whether the sub-lease is an operating lease or a finance lease, [compare the sub-lease term with the life of the ROU Asset \(original lease term\)](#) and not the underlying asset.
2. When the head lease is a short-term lease, the sub-lease will always be classified as an operating lease.
3. An intermediate lessor cannot account for the head lease as a lease of low value asset (irrespective of the value of the item).





SPECIAL CASES: SUB-LEASE (continued)

Accounting

Sub-lease is a Finance Lease



Lease Receivable A/c. Dr. (Net Investment)	xxx	
To ROU Asset		xxx
To Gain on Sale (P/L)		xxx

(original lease liability is NOT de-recognized)

Sub-lease is an Operating Lease



No entry at the time of sub-lease.
ROU Asset and Lease Liability both
continue to be recognized.



Page 7.188: Illustration 42 (Classification of a sub-lease in case of an Intermediate Lessor)

Entity ABC (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 40 years. Entity ABC subleases the building for four years.

How should the said sublease be classified by Entity ABC?

Page 7.190: Illustration 43 (Intermediate Lessor – Where the sublease is classified as a ‘Finance 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 beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e. three years of the head lease to a sub-lessee.

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

ICAI Illustrations



Page 7.190-191: Illustration 44 (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?

ICAI Illustrations



SPECIAL CASES: SALE AND LEASE BACK

What is a Sale and Lease Back?

It is a transaction which involves transfer of asset by one entity to another, and leaseback of the same asset by the original entity. Companies which have immediate cash requirements carry out such arrangements.

Sale and Leaseback

Control is transferred (Ind AS 115)

Accounted as a sale transaction



Derecognize underlying asset
and record gain / loss
(proportionate)

Control is NOT transferred

Accounted as a loan transaction



Bank A/c. Dr. xxx
 To Loan A/c. xxx
[Asset is NOT derecognized and
gain / loss is NOT recorded]

Where the sale happens at off-market terms, an adjustment will have to be made for:

- (a) The difference between fair value and sale price, OR
- (b) The difference between present value of contractual lease payments and the present value of fair lease payments

WHICHEVER is more readily determinable



SPECIAL CASES: SALE AND LEASE BACK (continued)

Sale and Leaseback at off market terms

Selling Price > Fair Value

OR Present Value of Actual Rent
> Present Value of Market Rent



The transaction contains a **Hidden Loan Arrangement**, which involves repayment in the form of excess lease payments



Reduce the Selling Price by the Loan Element

Selling Price < Fair Value

OR Present Value of Actual Rent <
Present Value of Market Rent



The transaction contains a **Hidden Prepaid Rent / Lease Payment**, which is adjusted in the future against reduced lease payments

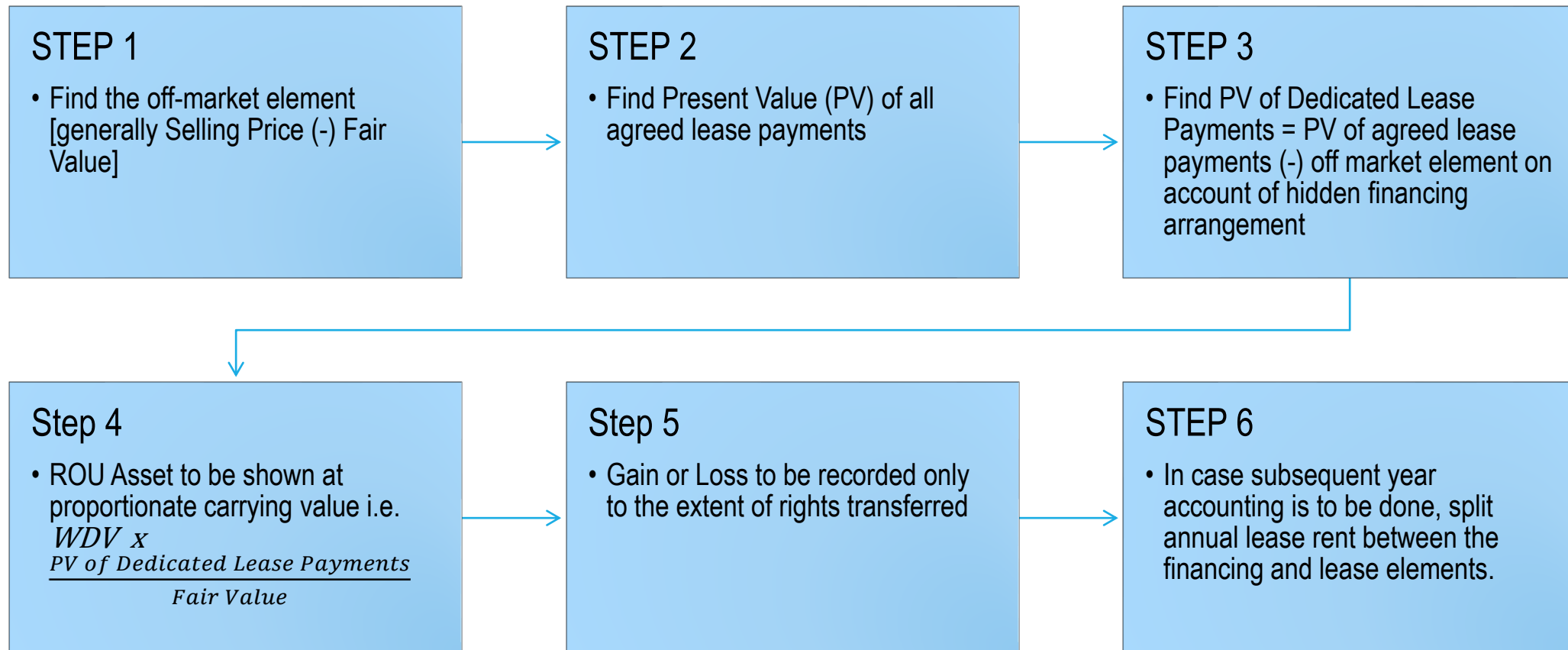


Increase the Selling Price by the prepaid element with a corresponding adjustment to ROU Asset



SPECIAL CASES: SALE AND LEASE BACK (continued)

ACCOUNTING WHEN SELLING PRICE > FAIR VALUE





Page 7.195: Illustration 45 (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.

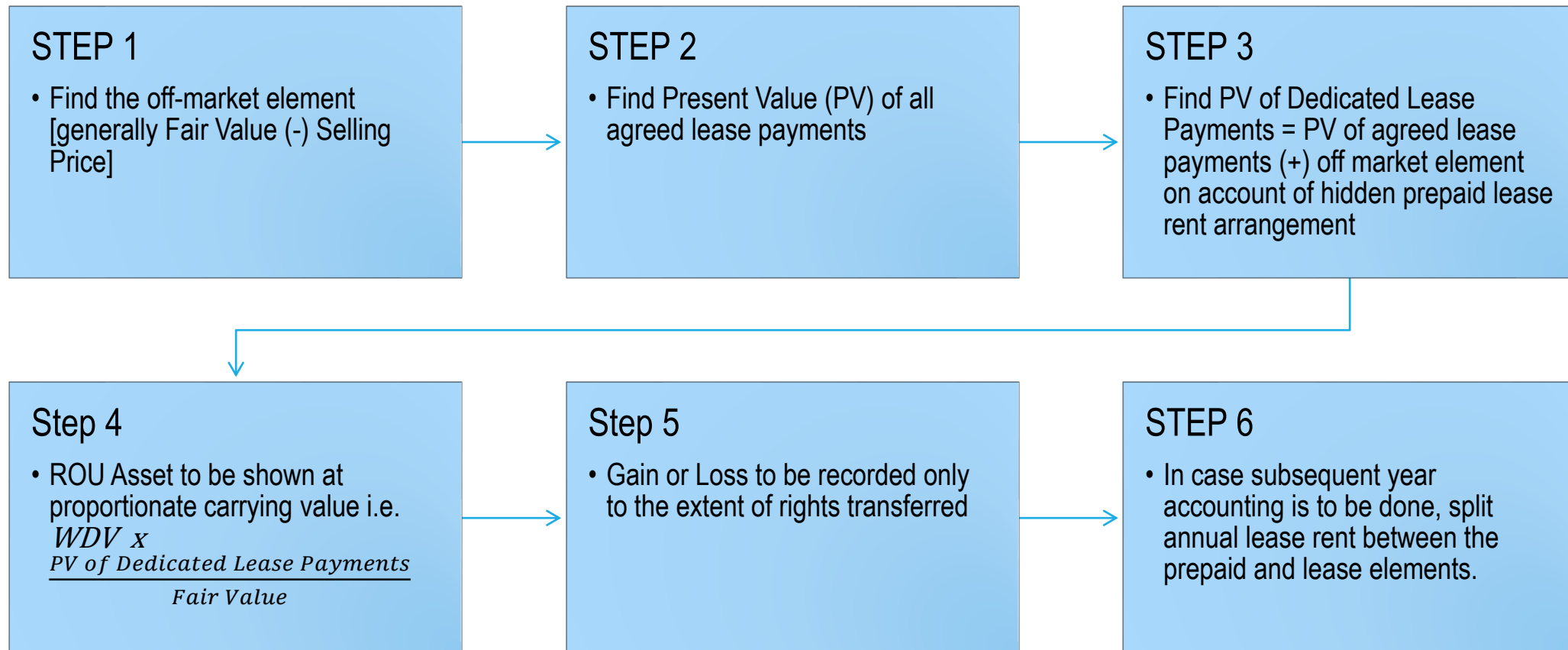
How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor?

ICAI Illustrations



SPECIAL CASES: SALE AND LEASE BACK (continued)

ACCOUNTING WHEN SELLING PRICE < FAIR VALUE





SPECIAL CASES: TRANSITION APPROACHES

- (a) The reporting entity is **not required to assess** separately whether an arrangement entered into prior to 1.4.2019 (date of applicability of Ind AS 116) contains a lease or not.
- (b) In case where the **original lease was classified as Finance Lease** under AS 19 / Ind AS 17, the **carrying values of the asset and lease liability would be taken as the carrying values of the ROU Asset and Lease Liability respectively** for applying Ind AS 116.

Where original lease was classified as Operating Lease under AS 19 / Ind AS 17

Full Retrospective Approach

Considering Ind AS 116 was always in force



Discount Rate to be the rate applicable on the commencement date



Retrospective restatement from the earliest reporting date

Modified Retrospective Approach

Option 1



- (a) Adjustment from 1.4.2019
- (b) Lease Liability = PV of remaining lease payments
- (c) ROU Asset to be retrospectively valued considering discount rate on 1.4.2019
- (d) No prior period restatement.

Option 2



- (a) Adjustment from 1.4.2019
- (b) Lease Liability = ROU Asset = PV of remaining lease payments based on discount rate as on 1.4.2019
- (c) No prior period restatement.



Page 7.203: Illustration 46 (Transition Approach)

A retailer (lessee) entered into 3-year lease of retail space beginning at 1 April 2017 with three annual lease payments of ₹ 2,00,000 due on 31 March 2018, 2019 and 2020, respectively. The lease is classified as an operating lease under Ind AS 17. The retailer initially applies Ind AS 116 for the first time in the annual period beginning at 1 April 2019. The incremental borrowing rate at the date of the initial application (i.e., 1 April 2019) is 10% p.a. and at the commencement of the lease (i.e., 1 April 2017) was 12% p.a. The ROU asset is subject to straight-line depreciation over the lease term. Assume that no practical expedients are elected, the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.

What would be the impact for the lessee using all the following transition approaches:

Full Retrospective Approach

Modified Retrospective Approach

- Alternative 1

- Alternative 2

ICAI Illustrations



SPECIAL CASES: LEASE MODIFICATIONS

A lease modification is negotiated / made after the lease commencement (i.e. after the ROU Asset and Lease Liability are already recorded), and could involve the following

- (a) Change in consideration (i.e. change in lease rent), OR
- (b) Change in tenure (i.e. change in lease term), OR
- (c) Change in scope (e.g. change in area of property taken on lease)

Lease modification could be accounted as a separate lease if:

An addition Right of Use in respect of the lease arrangement is obtained e.g. more area)

AND

The additional Right of Use is commensurate with its standalone selling price (with reasonable discounts permitted)

Where the above conditions are satisfied, the modification would be **accounted as a separate lease with a separate ROU Asset and a Lease Liability.**

The existing lease accounting will NOT be altered.



Page 7.157: 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?

ICAI Illustrations



SPECIAL CASES: LEASE MODIFICATIONS (continued)

Lease modifications (no separate lease created)

1. **Change (increase / decrease in Consideration)**

OR

2. **Increase in lease term**

OR

3. **Increase in scope (not at standalone price)**



Remeasure the Lease Liability at modification date with a corresponding adjustment to the ROU Asset.

The above adjustments are as if (1) asset is becoming costlier or cheaper, or (2) there is an addition to the ROU Asset in the form of increased lease term, or increased scope.

1. **Decrease in lease term**

OR

2. **Decrease in scope**



- (i) Derecognize proportionately the Lease Liability and ROU Asset
- (ii) Recognize Gain / Loss on modification in the P/L

The above adjustments are as if there is an sale of ROU Asset in the form of reduced lease term, or reduced scope.



Page 7.160: 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?

Page 7.164: Illustration 36 (Modification is a change in consideration only)

Lessee enters into a 10-year lease for 5,000 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 reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per 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. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

ICAI Illustrations



Page 7.162: Illustration 35 (Modification decreases the scope of the lease)

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 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 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.

How should the said modification be accounted for?

ICAI Illustrations



Page 7.165-166: Illustration 37 (Modification that both increases and decreases the scope of the lease)

Lessee enters into a 10-year lease for 2,000 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 6, Lessee and Lessor agree to amend the original lease to:

- (a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and*
- (b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹ 1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.*

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for?

ICAI Illustrations



SPECIAL CASES: REMEASUREMENT

Remeasurements

1. Reassessment of lease term (renewal / modification option)
2. Reassessment of purchase option (whether to be exercised or not)



Revised Discount Rate (at remeasurement date)

1. In-substance fixed lease payments
2. Future lease payments from a change in index / rate
3. Expected payable amounts under residual value guarantees



Continue with original discount rate



Page 7.153-154: Illustration 32 (Remeasurement of a lease with variable lease payments)

Entity W entered into a contract for lease of retail store with Entity J on January 01/01/20X1. The initial term of the lease is 5 years with a renewal option of further 3 years. The annual payments for initial term and renewal term is ₹ 100,000 and ₹ 110,000 respectively. The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 01/01/20X2 will be based on the CPI available at 31/12/20X1.

Entity W's incremental borrowing rate at the lease inception date and as at 01/01/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 01/01/20X4 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 20X4, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Is Entity W required to remeasure the lease in the first quarter of 20X4?

ICAI Illustrations



THANK YOU