UNIT 8: INDIAN ACCOUNTING STANDARD 116 : LEASES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- List the scope and explain the definitions given in the standard
- Comprehend the criteria for recognition of lease
- Analyse whether an arrangement contains a lease
- Identify and separate the lease and non-lease components of a contract
- Demonstrate the concept of inception and commencement of lease
- Determine lease term
- Identify other key concepts like lease payments, discount rate and economic life
- Provide the accounting in the books of lessee with respect to recognition, measurement, presentation and disclosure aspects
- Learn the accounting in the books of lessor with respect to recognition, measurement, presentation and disclosure aspects
- Produce accounting for subleases and sale and lease back transactions
- Apply the transitional provisions on applying Ind AS 116 for the first time.

UNIT OVERVIEW

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8.1 OVERVIEW

The Ministry of Corporate Affairs (MCA) has notified new standard on leases i.e Ind AS 116 vide its notification dated 30th March, 2019. Lease accounting has undergone significant changes on introduction of Ind AS 116 which is fully converged with IFRS 16. This new standard replaced the erstwhile Ind AS 17 and is effective from financial periods beginning on or after 1st April, 2019.

Ind AS 17 was based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them. The dual classification model did not account for the assets and liabilities associated with the rights and obligations that arise out of the most "operating" leases.

Under Ind AS 116, leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee. Ind AS 116, Leases, requires most leases to be recognized on the balance sheet and requires enhanced disclosures. It is believed that this will result in a more faithful representation of lessees' assets and liabilities and greater transparency about the lessee's obligations and leasing activities. However, Ind AS 116 does not make fundamental changes to existing lessor accounting model.

8.1.1 Objective

The objective of this standard is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. This standard requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances.

For many reporting entities, leasing is an important way to obtain access to property. A leasing arrangement conveys the use of an asset from one party to another without transferring ownership. The leasing arrangement may take various forms. Some arrangements are clearly within the scope of lease accounting, for example, property lease that provides an explicit contractual right to use a building for a specified period of time in exchange for consideration. However, the right to use an asset can also be conveyed through arrangements that are not leases in form.

Therefore, it is very critical to assess as to which arrangement contains a lease for assessing correct impact on financial position.

Ind AS 116, Leases, identifies arrangements that are to be accounted for as leases. This unit discusses how to identify which arrangements, or components within an arrangement, should be accounted for under Ind AS 116 and sets out the principles for the recognition, measurement, presentation and disclosure of leases.

8.1.2 Scope

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

S.N.	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.

8.1.3 Recognition Exemptions

In addition to above scope exclusions, a lessee can elect not to apply Ind AS 116's recognition requirements to:

1. Short-term leases; and
2. Leases for which the underlying asset is of low value

If a lessee **elects to apply** the above recognition exemption, the lessee shall recognise **the lease payments** associated with those leases as an expense on **either a straight-line basis over the lease term or another systematic basis**, if that basis is more representative of the pattern of the lessee's benefit.

Short term leases:

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset. As the determination is made at the commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months.

The short-term lease exemption can be made by **class of underlying asset** to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations.

For example, consider an entity which has leased several items of office equipment - some of them for less than 12 months and some for more than 12 months, with none containing purchase options. Assuming that the items of office equipment are all considered to be of the same class if the entity wishes to use the short-term lease exemption it must apply for that exemption for all the leases with terms of 12 months or less. The leases with terms longer than 12 months will be accounted for in accordance with the general recognition and measurement requirements for lessees.

A lessee that makes this election must make certain quantitative and qualitative disclosures about short-term leases. Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy.

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.

Analyze 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.

Advise will your answer be different in this case.

Solution:

Scenario A:

As the lessee is reasonably certain to exercise the extension option (Refer section 8.2 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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Leases of low-value assets:

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets).

Though Ind AS 116 does not explicitly define the leases of low-value assets, it provides the conditions based on which an asset can be treated as of low-value and the said exemption can be availed accordingly for such low-value asset(s). Following are the conditions:

An underlying asset can be of low value **ONLY IF BOTH** the following conditions are satisfied:

The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee

The underlying asset is not highly dependent on, or highly interrelated with, other assets

This can be understood with the help of the following **example**:

An entity may lease a car for use in its business and the lease includes the use of the tyres attached to the car. To use the tyres for their intended purpose, they can only be used with the car and as such, they are dependent on, or highly interrelated with the car. Therefore, the tyres would not qualify for the low-value asset exemption.

The election for leases for which the underlying asset is of low value can be made on a **lease-by-lease basis**. For example, an entity enters into a rental contract for a large number of laptops. Each laptop within the contract constitutes an identified asset. Entity has considered that the value of individual laptop would be low, even though the contract for all the laptops is not. The conditions of Para B5 of Ind AS 116 are satisfied i.e., the entity can benefit from use of an individual laptop together with other resources that are already available and each laptop does not need other assets to make it functional. Consequently, each laptop qualifies as a low value asset and the entity can elect to apply the low-value exemption to all the laptops under the contract.

The exemption for leases of low — value items intend to capture leases that are high in volume but low in value — e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. Ind AS 116 is silent on any threshold to determine the value for classifying any asset as low value assets.

The following boxes depicts the important points regarding the leases of low-value assets:

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.

*A lease of an underlying asset does not qualify as a lease of low value asset if the nature of the asset is such that, when new, the asset is typically not of low value. ***For e.g.***, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Head leases do not qualify as low value assets:

It is very important to note that 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, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. (Refer section 8.6.1 sublease)

Then, what should be the approach for such leases when the said exemptions are taken?

The lease payments shall be recognised as an expense on either a Straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

If a lessee accounts for "short-term leases" as per the approach mentioned above, it shall consider the lease to be a "new lease" for the purposes of Ind AS 116 if:

(a) there is a lease modification; ***OR***

(b) there is any change in the lease term

Recognition Exemptions

Short-term leases

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less

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A short-term lease does not include an option to purchase the underlying asset

This exemption can be made by **class of underlying asset** (assets of a similar nature and use) to which the right of use relates.

Note: A lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months

Leases for which the **underlying asset** is of low-value

ONLY IF BOTH the conditions are satisfied

The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee

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The underlying asset is not highly dependent on, or highly interrelated with, other assets

The exemption can be made on a **lease-by-lease basis**

Note:

1. The exemption for leases of low—value items intend to capture leases that are high in volume but low in value.
2. 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, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset.

8.2 WHAT IS A LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease. For the 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** in **exchange for consideration**.

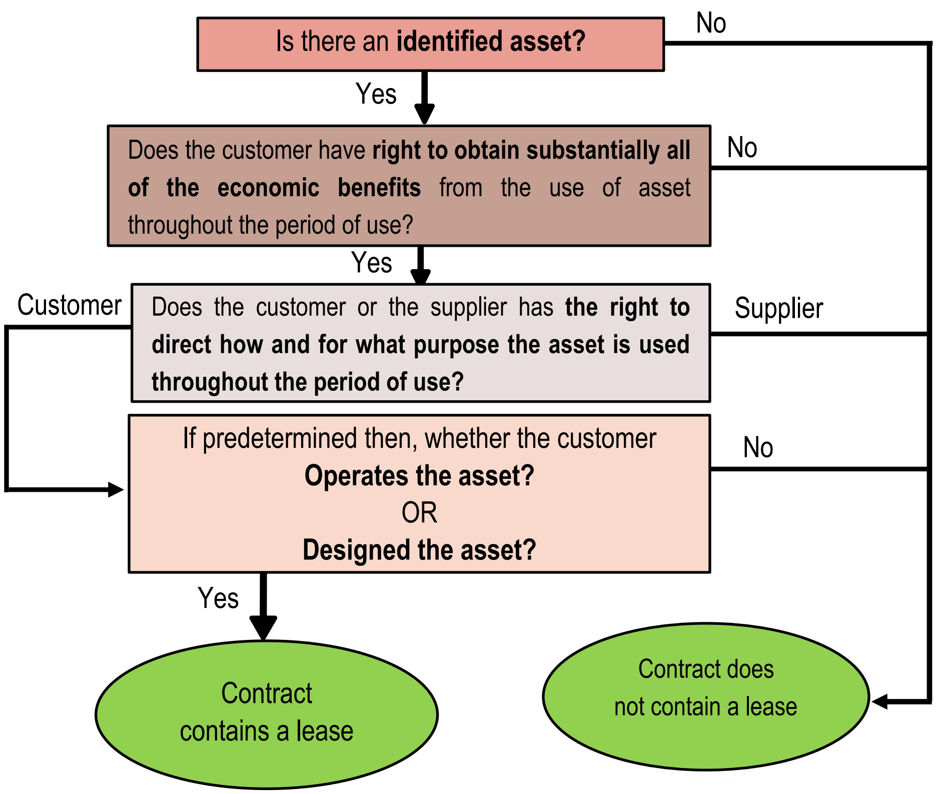
Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract.

The inception date is defined as the ***earlier*** of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease

'A period of time' may be described in terms of the amount of use of an identified asset (***for e.g.***, the number of production units that an item of equipment will be used to produce). It includes any non-consecutive periods of time.

8.2.1 Whether an Arrangement Contains Lease?



Comparison with AS 19:

AS 19 neither does provide additional guidance regarding "right to direct", nor does it provide any guidance regarding cases of pre-determined activities. AS 19, in general, considers

8.2.1.1 Identified Asset

An arrangement only contains a lease if there is an **identified asset**. Under Ind AS 116, an identified asset can be explicitly specified in a contract or implicitly specified at the time that the asset is made available for use by the customer.

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.

Comment whether there is an identified asset.

Solution:

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

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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.

State whether there is an identified asset.

Solution:

Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is **implicitly specified** at the time the same will be made available to Customer XYZ.

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Substantive Substitution Rights:

This is a very important concept since without evaluating this condition, the conclusion as to whether there is an identified asset cannot be attained. So, even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

A supplier's right to substitute an asset is **SUBSTANTIVE** when **BOTH** of the following conditions are met:

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

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The supplier 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 associated with substituting the asset).

→ Substantive Substitution Rights

The conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective. Examples of factors to consider include (1) transportation costs of relocating one asset to a location where it can be used to satisfy the arrangement or to move the output from the production location to the customer, (2) foregone production resulting from down time necessary to switch assets and other disruptions to the suppliers' business, (3) excess operational costs to convert an asset that may not have produced identical output, etc.

Further, if the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.

An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. Ind AS 116 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

(1)
An agreement by a future customer to pay an above market rate for use of the asset

(2)
The introduction of new technology that is not substantially developed at inception of the contract

(3)
A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract

(4)
A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract

The requirement that a substitution right must **benefit the supplier economically** in order to be substantive is a new concept. In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. ***For***

e.g., if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**. However, suppliers should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (***for e.g.***, a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

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 for 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 optimize 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.

Analyze 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 customized, and the supplier does not have the practical ability to substitute the customized asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Solution

Scenario A:

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute for the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (***for e.g.***, there is insufficient transparency into the supplier's operations), the customer would **presume** the substitution right is not substantive and conclude that there is an identified asset.

Scenario B:

The substitution right is not substantive, and Server No. 10 would be an identified asset because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

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Comparison with AS 19:

AS 19 does not include any requirement for substantive substitution right. Hence, even if a lessor has substantial substitution right, the contract may be accounted for as a lease under AS 19.

Identified Asset – Physically Distinct:

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors. Similarly, a capacity or other portion of an asset that is not physically distinct (***for e.g.***, a 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.

The term "substantially all" is not defined in Ind AS 116.

This can be better understood with the help of the following illustrations:

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.

Examine whether there is an identified asset.

Solution:

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract.

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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.

Examine 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.

Assess whether there is an identified asset.

Solution:

Scenario A:

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents **substantially all of the capacity** of the entire pipeline and thereby provides

Customer XYZ with the **right to obtain substantially all of the economic benefits** from use of the pipeline.

Scenario B:

No, the capacity portion of the pipeline is **NOT** an identified asset.

Since 65% of the pipeline's capacity is **less than substantially all** of the capacity of the pipeline, Customer XYZ does **not have the right to obtain substantially all of the economic benefits** from use of the pipeline.

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8.2.1.2 Right to Control

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) The right to obtain **substantially all of the economic benefits** from use of the identified asset; **and**

(b) The **right to direct the use** of the identified asset

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease.

Further, if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

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.

Recommend which party has the right to control the use of the identified asset during the period of use.

Solution:

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

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Right to Obtain Substantially All of the Economic Benefits:

The first criterion in the control assessment is to determine whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, i.e., to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (***for e.g.***, by having exclusive use of the asset throughout that period).

A customer can obtain economic benefits either **directly** or **indirectly** (***for e.g.***, by using, holding or subleasing the asset). Economic benefits from use of an asset include:

- the asset's primary outputs (i.e., goods or services)
- any by-products (***for e.g.***, renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items.
- benefits from using the asset that could be realised from a commercial transaction with a third party (***for e.g.***, subleasing the asset)

When assessing whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, an entity must consider the economic benefits that result from use of the asset within the **defined scope** of the customer's right to use the asset.

For example:

(a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity considers only the economic benefits from use of the motor vehicle within that territory, and not beyond; or

(b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity considers only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.

A right that **solely protects** the supplier's interest in the underlying asset (***for e.g.***, limits on the number of miles a customer can drive a supplier's vehicle as explained in the above example) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, are **not considered** when assessing whether a customer has the right to obtain substantially all of the economic benefits.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (***for e.g.***, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use), that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

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.

Examine who has the right to substantial benefits from the solar farm.

Solution:

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar farm over the 15-year period because it obtains:

- the electricity produced by the farm over the lease term — i.e. the primary product from use of the asset; and
- the renewable energy credits — i.e. the by-product from use of the asset.

Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

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Right to Direct the Use of the Identified Asset

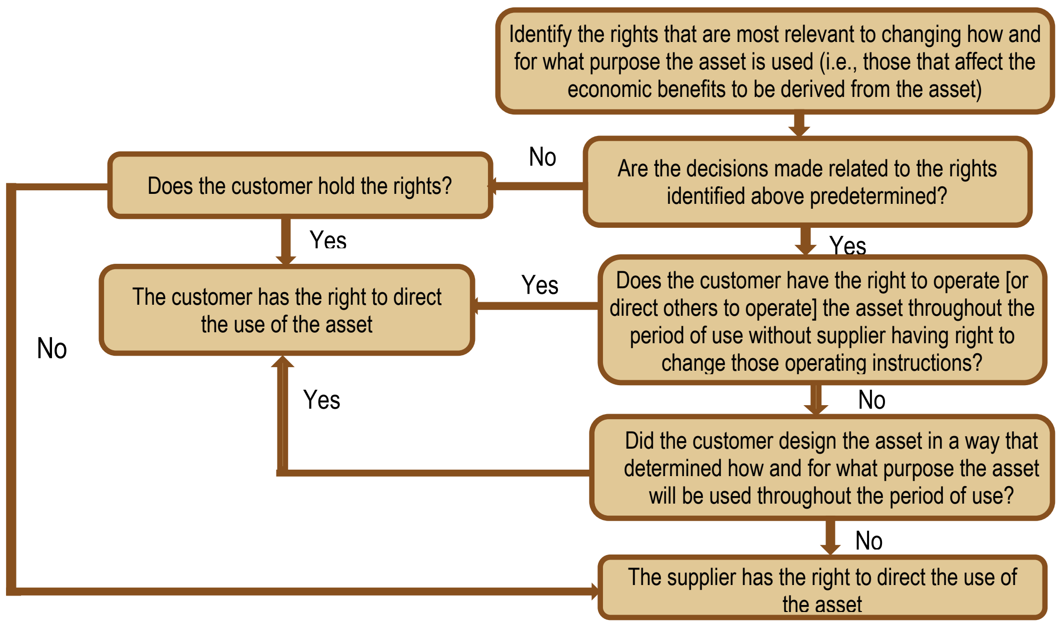
The second criterion in the control assessment is to determine whether the customer has the right to direct the use of the identified asset throughout the period of use.

Decisions about **how and for what purpose an asset will be used are the most relevant factors** to consider when assessing which party directs the use of the identified asset. Because such rights determine the economic benefits that can be derived from using the asset during the period of use.

Decisions regarding **where and when the asset is to be used are likely to be more important** than how those decisions are implemented. For example, if a customer outsources operation of an asset to an outside service provider, the outsourcing does not typically influence the economic benefits that can be derived from the asset.

In some arrangements, the decisions related to how and for what purpose an asset is used, are already specified in the contract before the lease term commences. These decisions will need to be considered in conjunction with decisions made during the period of use to properly identify the party that directs the assets' use. Simply specifying the output prior to the term does not, on its own, constitute the ability to direct the use.

The following figure illustrates the analysis that should be used to determine which party has the right to direct the use of an identified asset.



A customer has the right to direct the use of an identified asset whenever it has the right to direct **how and for what purpose** the asset is used throughout the period of use (i.e., it can **change** how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a **SINGLE CONCEPT** (i.e., 'how' an asset is used is **not assessed separately** from 'for what purpose' an asset is used).

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the **decision-making rights that will most affect the economic benefits** that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Ind AS 116 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

Particulars	***Examples***
The right to change the type of output that is produced by the asset	(i) Deciding whether to use a shipping container to transport goods or for storage (ii) Deciding on the mix of products sold from a retail unit
The right to change when the output is produced	Deciding when an item of machinery or a power plant will be used
The right to change where the output is produced	(i) Deciding on the destination of a truck or a ship (ii) Deciding where a piece of equipment is used or deployed
The right to change whether the output is produced and the quantity of that output	Deciding whether to produce energy from a power plant and how much energy to produce from that power plant

Although **the decisions about maintaining and operating the asset** are often essential to the efficient use of that asset, the right to make those decisions, **in and by itself, does not result** in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does **not need the right to operate** the underlying asset to have the right to direct its use, i.e., the customer may direct the use of an asset that is operated by the supplier's personnel. However, the right to operate an asset will often provide the customer with the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

The relevant decisions about how and for what purpose an asset is used are predetermined:

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when

- the most relevant decisions about how and for what purpose an asset is used are **predetermined by contractual restrictions** on the use of the asset (***for e.g.***, the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed) ***OR***
- the most relevant decisions about how and for what purpose an asset is used are, in effect, **predetermined by the design of the asset**

In cases where the decisions about how and for what purpose an asset is used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the **right to operate** the asset, ***OR*** **direct others to operate** the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions ***OR***
- **Designed** the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Specifying the output of an asset before the period of use
If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does **not have the right to direct the use of that asset unless** it designed the asset, ***OR*** specific aspects of the asset. If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (***for e.g.***, the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

Protective rights
A supplier's protective rights, **in isolation, do not prevent the customer from having the right to direct the use** of an identified asset.

Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests. For example, a contract may

(i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset,

(ii) require a customer to follow particular operating practices, or

(iii) require a customer to inform the supplier of changes in how an asset will be used.

Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

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 for 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.*

State whether Customer X has the right to direct the use of the vehicle throughout the period of lease.

Solution:

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the **right to change** how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered **protective rights** that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

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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.

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

Solution:

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

*****

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.

State who has the right to direct the use of the ship during the period of use.

Solution:

Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five — year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

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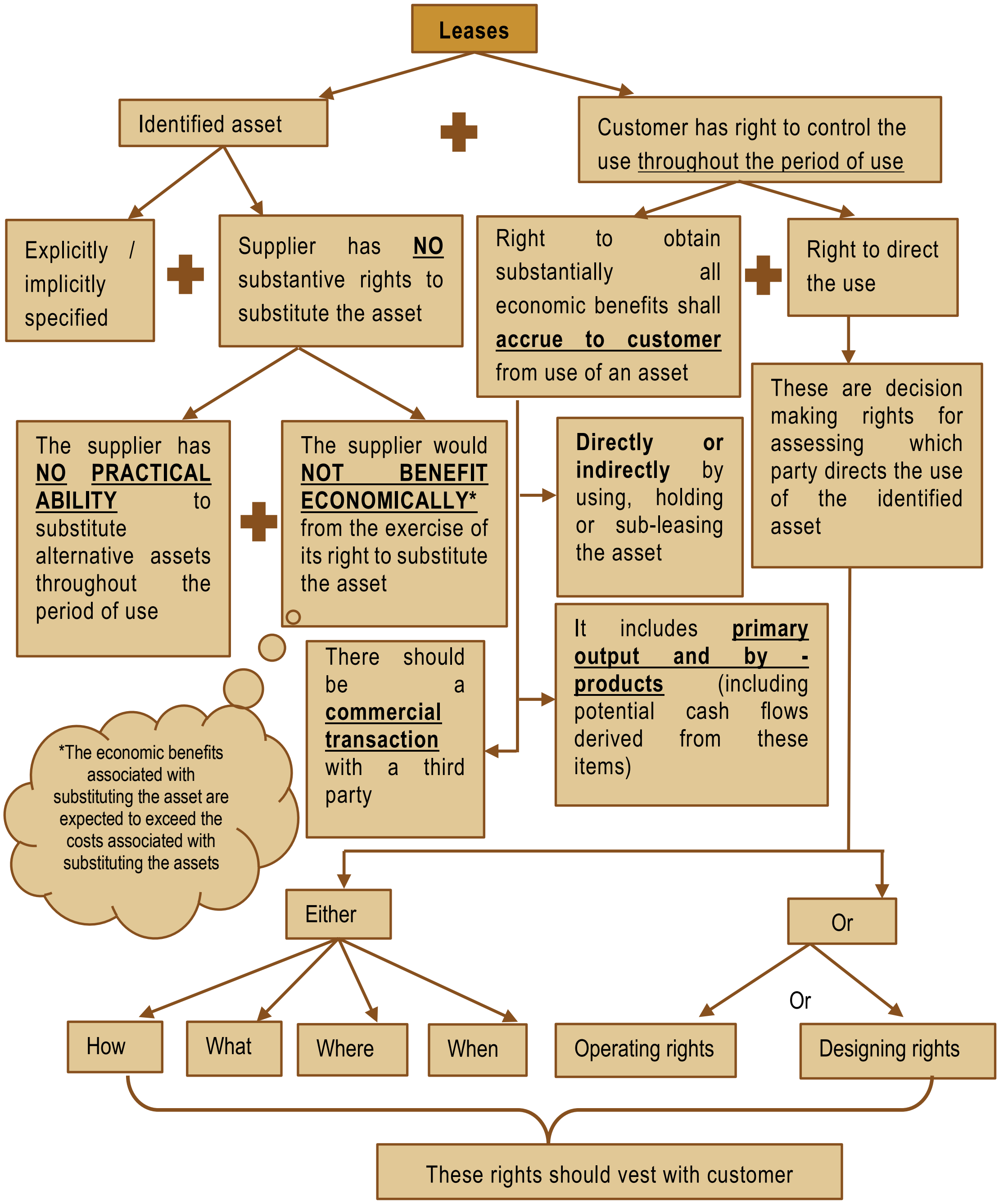
The concept explained in para 8.2.1 has been summarised as follows:



*The economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset

Note:

1. In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective.

2. If the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.

3. An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur.

4. Contract terms that allow or require a supplier to substitute alternative assets only when the underlying **asset is not operating properly** (***for e.g.***, a normal warranty provision) or when a **technical upgrade** becomes available **do not create a substantive substitution right**.

5. Circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use.

6. The right to control the use of an asset may not necessarily be documented, in the form as a lease agreement.

7. Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**.

8. An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. Similarly, a capacity or other portion of an asset that is not physically distinct 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.

8.2.2 Separation of Lease and Non-Lease Components

8.2.2.1 Identifying and separating lease components of a contract

Sometimes, there are contracts that contain rights to use multiple assets (***for e.g.***, a building and an equipment, multiple pieces of equipment, etc.). The right to use each such asset is considered as a 'separate' lease component **ONLY IF BOTH** the following conditions are satisfied:

- The lessee can benefit from the use of the asset either on its own ***OR*** together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events) ***AND***
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met then, the right to use multiple assets is considered a 'single' lease component, i.e., not a 'separate' lease component.

Identifying and separating lease components of a contract

↓

The right to use each asset is considered as a 'separate' lease component

← **ONLY IF BOTH** the following conditions are

The lessee can benefit from the use of the asset either on its own ***OR*** together with other resources that are readily available to the lessee	+	The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract

Note: If one or both criteria are not met then, the right to use multiple assets is considered as a 'single' lease component, i.e., not a 'separate' lease component

Let us have a look at the following illustration to have a better understanding:

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.*

State 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).*

Solution:

Scenario A:

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B:

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz., a lease of the excavator (together with the accessories) and a lease of the loading truck.

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8.2.2.2. Separating lease components from non-lease components:

There may be many contracts containing a lease coupled with an agreement to purchase or sell other goods or services (i.e., the non-lease components under Ind AS 116). For example, a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). This service is not related to securing the use of the truck. The only items that contribute to securing the output of the asset are lease components. In this example, only the use of the truck is considered a lease component. Similarly, costs incurred by a supplier to provide maintenance on an underlying asset, as well as the materials and supplies consumed as a result of the use of the asset, are not lease components.

The non-lease components are identified and accounted for separately from the lease component in accordance with other standards. ***For e.g.***, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to Ind AS 115 by lessors (suppliers).

Costs related to property taxes and insurance do not involve the transfer of a good or service. Consequently, if these costs are fixed in the contract, they should be included in the overall contract consideration to be allocated to the lease and non-lease components.

Lessee reimbursements – whether a separate component of a contract?

As already discussed above that under Ind AS 116, payments for maintenance activities, including common area maintenance (***for e.g.***, cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the lessee (***for e.g.***, providing utilities or rubbish removal) are considered as **non-lease components** because they provide the lessee with a service.

But, in some leases, a lessee also may **reimburse (or make certain payments on behalf of)** the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (***for e.g.***, payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is).

Under Ind AS 116, such costs are **not separate components of the contract** because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components, if any).

Illustration 13 - Identifying different components in the 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 a 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.

State what are the units of account in the lease.

Solution:

There are three components in the arrangement – the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use.

The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

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<u>Optional exemption of using Practical Expedient to not to separate non-lease component</u>

Ind AS 116 provides a practical expedient that permits lessees to make an **<u>accounting policy election</u>**, by **<u>CLASS OF UNDERLYING ASSET</u>**, to account for each separate lease component of a contract and any associated non-lease components as a **<u>SINGLE LEASE COMPONENT</u>**. It is important to note that such practical expedient is not permissible for lessor.

Making this election relieves the lessee of the obligation to perform a pricing allocation, although it will increase the total lease liability to be recorded on its balance sheet. This expedient is not available for lessors. Lessees that make the **<u>policy election</u>** to account for each separate lease component of a contract and any associated non-lease components as a **<u>SINGLE LEASE COMPONENT</u>**, **<u>allocate ALL of the contract consideration to the lease component</u>**.

It is very important to note that the practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component, if it meets the conditions provided in Section 8.2.2.1.

Comparison with AS 19:

AS 19 does not contain any guidance on separation of lease and non-lease components. It seems that AS 19 requires accounting for the entire contract including the non-lease components. The Scope of AS 19 mentions that "*AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles, and computers.*" Hence, one would be required to account for the entire contract as a lease under AS 19, without separating the non-lease components.

8.2.2.3 Determining and allocating the consideration in the contract – Lessee

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient, as discussed above, to account for each separate lease component of a contract and any associated non-lease components as a single lease component, are required to **allocate** the consideration in the contract to the lease and non-lease components on a **RELATIVE STAND-ALONE PRICE BASIS**.

Lessees are required to use **observable** stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees **estimate** stand-alone prices, maximizing the use of observable information.

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 for administrative tasks.

Explain 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.

Explain how the consideration would be allocated.

Solution:

Scenario A:

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B:

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

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

A lessee enters into a lease of 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, maximizing 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, explain how will the lessee allocate the consideration to lease and non-lease component?

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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8.2.2.4 Determining and allocating the consideration in the contract – Lessors:

Lessors are required to **allocate** the consideration in the contract to the lease and any associated non-lease components by applying paragraphs **73 – 90 of** Ind AS 115 *Revenue from Contracts with Customers.*

8.2.3 Contract Combinations

Ind AS 116 requires that two or more contracts entered into at or near the **same time** with the **same counterparty** (**or related parties of the counterparty**) be considered a **'single' contract IF ANY ONE** of the following criteria is met:

The contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together

OR

The amount of consideration to be paid in one contract depends on the price or performance of the other contract

OR

The rights to use the underlying assets conveyed in the contracts (or some of the rights to use underlying assets conveyed in each of the contracts) are a single lease component

8.2.4 Portfolio Application

Ind AS 116 applies to individual leases. However, entities that have a large number of leases of similar assets (***for e.g.***, leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis.

Thus, Ind AS 116 includes a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio. If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio.

This approach is consistent with that under Ind AS 115. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

Comparison with AS 19:

AS 19 does not provide any guidance on combining contracts or portfolio application of principles.

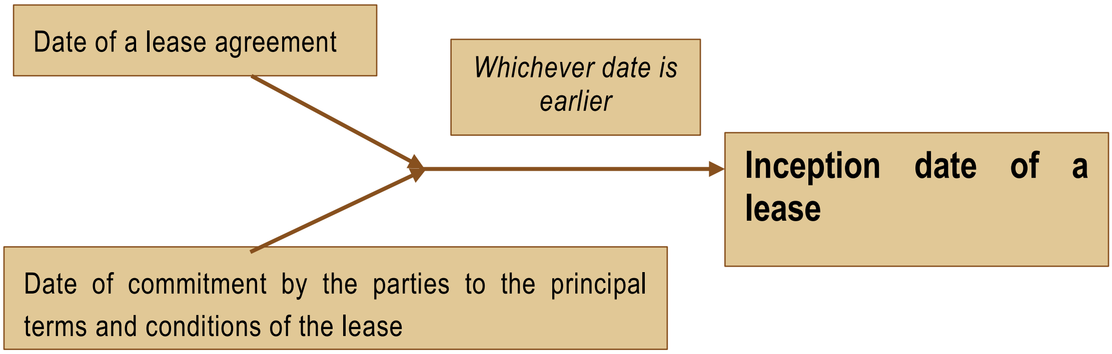
8.3 KEY CONCEPTS

8.3.1 Inception and Commencement of Lease

Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the **inception** of the contract.

The **inception date** is defined as the *earlier* of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease



The **commencement date** is defined as the date on which a lessor makes an underlying **asset available for use** by a lessee. Where, the '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.

In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement (***for e.g.***, the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (***for e.g.***, during the period a lessee uses the leased space to construct its own leasehold improvements).

If a lessee takes possession of, or is given control over, the use of the underlying asset **before** it begins operations or making lease payments under the terms of the lease, **the lease term has commenced even if** the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date.

The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

As discussed earlier, **inception date** is the date when an entity shall **assess** if the contract is or contains lease. While the **commencement date** is relevant because on that date**:**

(i) a lessee (except where the exemption of short-term lease or low-value asset is taken) **initially recognises a lease liability** and related Right of Use Asset (hereinafter referred to as "ROU Asset") on the commencement date

(ii) a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

Where, **'ROU Asset'** is defined as an asset that represents a lessee's right to use an **underlying asset** for the **lease term**.

Commencement date of a lease

The **commencement date** is the date on which a lessor makes an **underlying asset* available for use** by a lessee

*The **'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

On this date

a lessee initially recognises

- a lease liability and
- related Right of Use Asset (ROU Asset)*

a lessor (for finance leases) initially recognizes

- its net investment in the lease

***'ROU Asset'** represents a lessee's right to use an **underlying asset** for the **lease term**

Note:

- In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement.
- The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

8.3.2 Lease Term

Determination of the lease term is a very crucial step before the calculation of the Lease Liability and the corresponding ROU Asset.

In simple terms, lease term is the **summation** of the following:

	Particulars	Years
1	Rent free period	XXX
2	Non-cancellable period	XXX
3	Optional renewable periods (where lessee is reasonably certain to extend the lease)	XXX
4	Periods covered by option to terminate the lease (where lessee is reasonably certain not to terminate early)	XXX
	Total Lease terms	**XXXX**

The lease term begins at the lease **commencement date**. The lease term starts when the lessor makes the underlying asset available for use by the lessee and includes any rent-free periods provided.

The assessment of whether it is reasonably certain that a lessee will exercise an extension or termination option **should be done on lease commencement date.** An entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. The assessment should not be based solely on the lessee's intentions, past practices, or estimates. It should focus on the factors that create an economic incentive for the lessee, including contract, asset, entity, or market-based factors. Example of relevant factors to consider are:

Contractual terms vis-a vis market rates	Asset related factors
1. Lease rentals in optional period, ex. Termination penalties and residual value guarantees	1. Specialised asset
2. Variable or contingent payment	2. Location of underlying asset
3. Terms and condition after initial optional period, ex. Purchase option	3. Availability of suitable alternatives
4. Cost relating to the termination of the lease and signing of new replacement lease	4. Existence of significant leasehold improvement

In certain cases, it can be more difficult to determine whether the exercise of the option is reasonably certain where the period from the commencement of the lease to the exercise date of an option is longer. The said difficulty arises from several factors. ***For e.g.***, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

An artificially short lease term (***for e.g.***, a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. ***For e.g.***, a company that leases a specialized facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centers to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods.

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.

Explain 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.

Describe 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.

Explain the lease term.

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 Entity ABC is not reasonably certain to exercise the option because there are no penalties or other factors which indicate that the entity will opt for renewal of lease.

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.

*****

Cancellable leases:

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A 'contract' is defined as an agreement between two or more parties that creates enforceable rights and obligations.

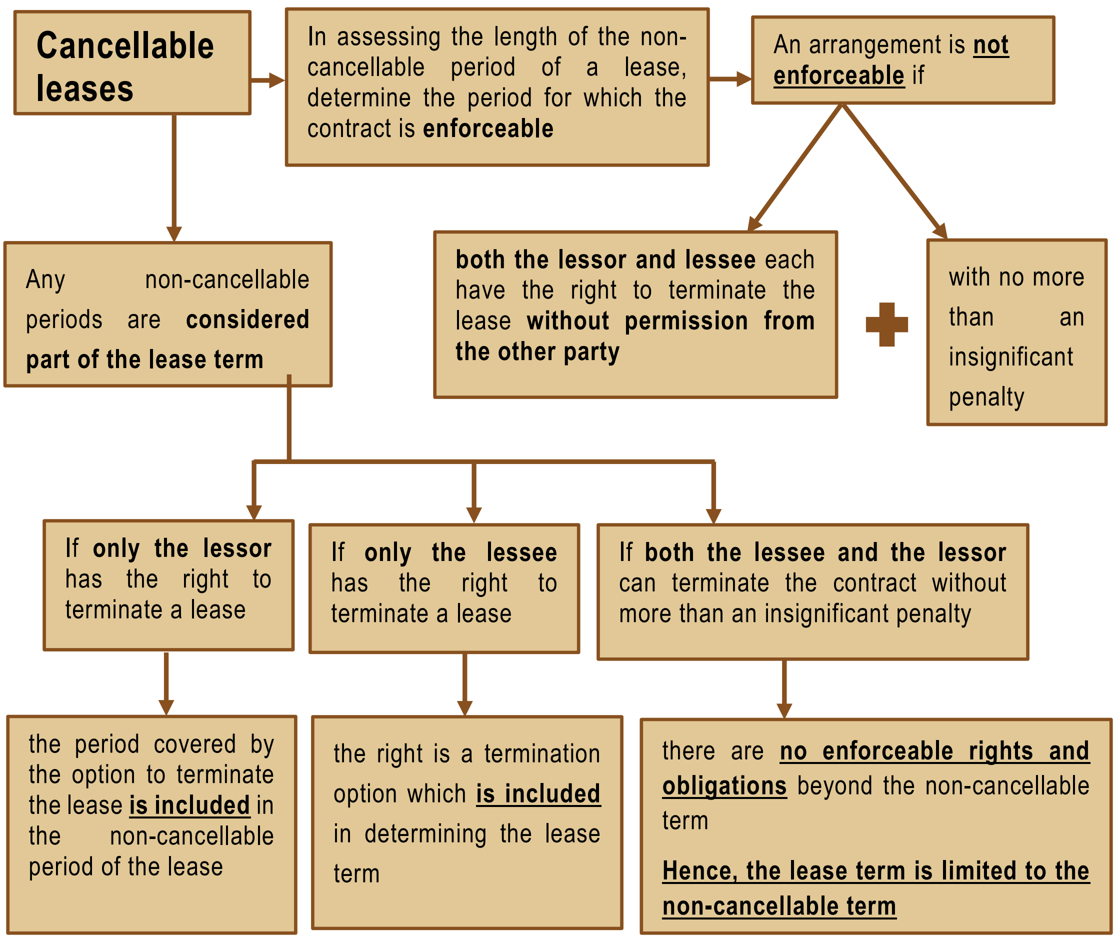
An arrangement is **not enforceable** if:

(i) both the lessor and lessee each have the right to terminate the lease without permission from the other party; **AND**

(ii) with no more than an insignificant penalty

Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term.

Ind AS 116 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations. Thus, Ind AS 116 applies to contracts that are referred to as 'cancellable', month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (***for e.g.***, the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider determining whether the lessee is reasonably certain to extend the lease, including economic disincentives (as discussed above).



This can be understood better with the help of the following illustrative situation:

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.*

Reassessment of lease term and purchase options (for lessees):

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:

Is within the control of the lessee

+

Affects whether the lessee is reasonably certain to exercise / not to exercise renewal, termination and/or purchase option, not previously included in its determination of the lease term

Following are some of the examples of significant events or significant changes in circumstances within the lessee's control:

1) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

2) Making significant modifications or customisations to the underlying asset

3) Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)

4) Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (***for e.g.***, a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and therefore, they **do not trigger a reassessment by themselves**.

Ind AS 116 also requires lessees to revise the lease term if there is change in the non-cancellable period of lease. Following are the example which leads to change in non-cancellable period of a lease:

Change in non-cancellable lease period

If the lessee **exercises an option** not previously included in the entity's determination of the lease term	If the lessee **does not exercise an option** previously included in the entity's determination of the lease term;
An event occurs that **contractually obliges the lessee** to exercise an option not previously included in the entity's determination of the lease term	An event occurs that **contractually prohibits** the lessee from exercising an option previously included in the entity's determination of the lease term.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in the circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances.

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.

Analyze whether 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, 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 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.

Examine 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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<u>Reassessment of lease term and purchase options (for lessors):</u>

Ind AS 116 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

Comparison with AS 19:

AS 19 does not contain any guidance on re-assessment or changes to lease term.

8.3.3 LEASE PAYMENTS

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), **<u>less</u>** any lease incentives

(b) variable lease payments that depend on an index or a rate

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees.

For the lessors, lease payment instead includes residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

<u>Exclusion of payments for calculating lease liability:</u>

a. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

b. Variable lease payments that do not depend on index or rate.

8.3.3.1 Fixed lease payments

<u>'Fixed payments'</u> are defined as payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.

Fixed payments can either be a fixed amount paid at various intervals in a lease (e.g., a five-year equipment lease with annual lease payments of ₹ 20,000) or they can be payments that change over time (e.g., lease payments of ₹ 20,000 per month at lease commencement that increase annually by ₹ 2,500 per month).

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.

State the fixed lease payments for the purpose 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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<u>In-substance fixed lease payments:</u>

As mentioned above, lease payments also include any in-substance fixed lease payments which are the payments that may, **<u>in form</u>**, contain variability but that, **<u>in substance</u>**, are unavoidable. Examples may include:

(a) if payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance.

Examples of those types of payments include:

- payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; ***OR***

- payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.

(b) if there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In such a case, an entity shall consider the realistic set of payments to be lease payments.

(c) if there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In such a case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

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.*

Explain what is considered as lease payment in this case.

Solution:

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

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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.

Describe the lease payments for the purpose 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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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.

Determine the lease payment.

Solution:

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

*****

Lease incentives

'Lease incentives' is defined as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving / transportation expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessee, lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.

For lessors, lease incentives are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease. Consequently, the selling profit or loss is not affected. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

Lessor reimbursement for some (or all) of the costs a lessee incurs to complete leasehold improvements is a common example of a lease incentive. To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting entity should evaluate the nature of the improvement and determine whether it represents an asset for lessee or a lessor. If an improvement represents an asset for lessee, the lessor payment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the other hand, reimbursement for an improvement that is an asset for lessor is not a lease incentive; it should be recorded as a reimbursement to the lessee for the cost of the asset of lessor.

8.3.3.2 Variable lease payments that depend on an index or a rate:

'Variable lease payments' are defined as the portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

These may include, ***for e.g.***, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as SOFR) or payments that vary to reflect changes in market rental rates. Such payments are **included** in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement).

Despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (for lessor) and a liability (for lessee) because they are **unavoidable** and **do not depend on any future activity** of the lessee. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

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.

Determine the 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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Variable lease payments that do not depend on an index or a rate:

Variable lease payments that do not depend on an index or rate and are **not, in substance, fixed** (as discussed above – In-substance fixed lease payments). Examples may include payments such as those based on performance (***for e.g.***, a percentage of sales) or usage of the underlying asset (***for e.g.***, the number of hours flown, the number of units produced), are **not included** as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the ROU Asset).

When variable payments not included in consideration in the contract are recognized, lessees also allocate these amounts between lease and non-lease components on the same basis as the allocation of consideration in the contract. These payments include variable payments not based on an index or rate or the changes in variable payments based on an index or rate after the commencement date of the lease.

Illustration 24 - Variable lease payments that do not depend on an index or rate

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.

Analyze whether these payments affect the calculation of lease liability and ROU Asset. Further discuss how Entity XYZ and Customer ABC would allocate these lease payments.

Solution:

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract (assuming Customer ABC does not elect to combine lease and non-lease components for this class of asset).

If Customer ABC elects the practical expedient not to separate the associated non-lease component from the lease component and instead accounts for the lease component and the non-lease component as a single lease component, the future payments for the consumables will still constitute genuine variability. Hence there will also be no lease payments for purposes of initial measurement.

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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

Solution:

As stated above, payments are due at the end of the year. Entity A elects to apply the practical expedient not to separate lease and non-lease components.

At the commencement date, Entity A measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of ₹ 5,00,000). Although Entity A has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, Entity A excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because Entity A has elected not to separate them from the fixed lease payments. Entity A recognises the payments for water – as a variable lease payment – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water – as an operating expense – in profit or loss when they are incurred.

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8.3.3.3 Exercise price of a purchase option

If the lessee is **reasonably certain** to exercise a purchase option, the exercise price is **included** as a lease payment, i.e., entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (as discussed earlier).

8.3.3.4. Penalties for terminating a lease

If it is **reasonably certain** that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is **excluded** from the lease payments. **Otherwise**, the lease termination penalty is **included** as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options (as discussed earlier).

8.3.3.5. Residual value guarantees (lessees):

'Residual value guarantee' is defined as a guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.

For a lessee, lease payments include amounts expected to be **payable by the lessee** under residual value guarantees. A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least of a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee.

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?

Solution:

The lessee should include the amount of ₹ 8,000 as a lease payment because it is expected that it will owe the same to the lessor under the residual value guarantee.

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Residual value guarantees (lessors):

Ind AS 116 requires lessors to **include** in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. This amount included in the lease payments is **different** from that for a lessee which only includes the amount expected to be payable by lessee only (as discussed above).

The concept explained in para 8.3.3 above can be summarized in the next page.

Lease payment for the Lessors

Lease payment for the Lessees

- fixed payments (including in-substance fixed payments), **<u>less</u>** any lease incentives*
- variable lease payments that **<u>depend on an index or a rate</u>** measured using the prevailing rate at the measurement date**
- exercise price of a purchase option if the lessee is **<u>reasonably certain</u>** to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee **<u>exercising an option to terminate</u>** the lease
- expected residual value guarantees payable by the lessee
- residual value guarantees provided by the lessee or a third party related to the lessee or unrelated to the lessor

It includes any **in-substance fixed lease payments** which are the payments that may, **<u>in form</u>**, **<u>contain variability but in substance</u>**, **<u>are unavoidable</u>**

***Lease incentives**

- **For lessee -** lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.
- **For lessors -** lease incentives are also deducted from lease payments and affect the lease classification test.
  - **For finance leases**
    - lease incentives reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease.
    - Selling profit or loss is not affected.
  - **For operating leases**
    - defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

**Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

<u>Exclusion of payments for calculating lease liability:</u>

a. **Lease payments allocated to non-lease components of a contract,** unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

b. Variable lease payments that **<u>do not</u>** depend on index or rate. They are recognised in profit or loss in the period in which the event that triggers the payment occurs.

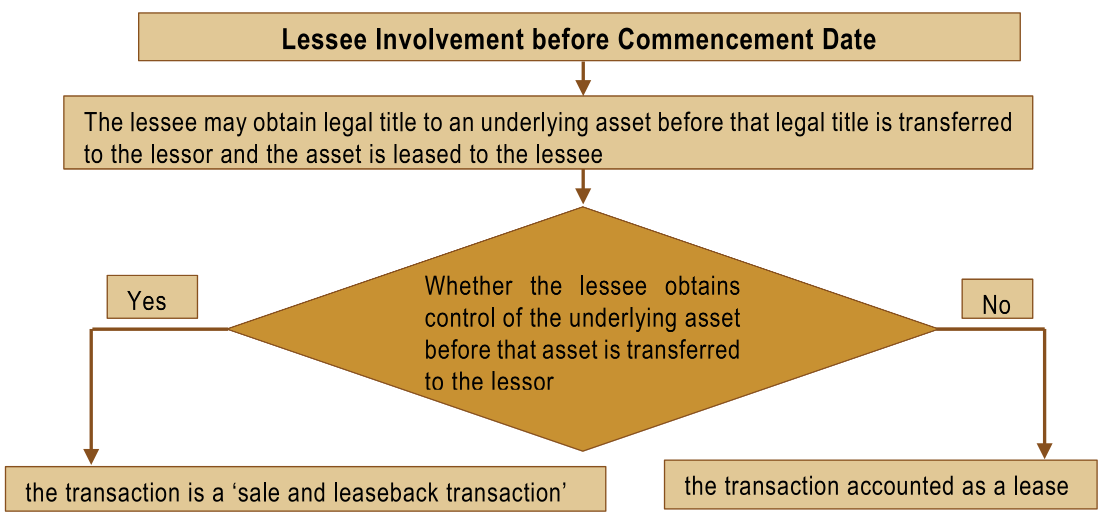
8.3.4 Lessee Involvement before Commencement Date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Thus, based on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset since, payments for the right to use an underlying asset are the payments for a lease, regardless of the timing of those payments. Thus, if the lessee incurs such costs, they are accounted by applying other Ind AS (such as Ind AS 16, Property, Plant and Equipment).

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a 'sale and leaseback transaction' (Please refer Section 8.6.2 'Sale and Leaseback Transactions' for further discussion)

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a 'sale and leaseback transaction'. ***For e.g.***, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but it is rather accounted as a lease.



8.3.5 Initial Direct Costs

'Initial direct costs' are defined as **the 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.

Ind AS 116 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

Examples of costs included and excluded from initial direct costs is provided below.

Included	Excluded
Commission (including payments to employees acting as selling agents)	Employee salaries
Legal fees resulting from the execution of the lease	Legal fees for services rendered before the execution of the lease
Lease document preparation costs incurred after the execution of the lease	Negotiating lease term and conditions
Certain payments to existing tenants to move out	Advertising
Consideration paid for a guarantee of a residual asset by an unrelated third party	Depreciation and amortization

Lessees and lessors apply the same definition of initial direct costs. The requirements under Ind AS 116 for initial direct costs are consistent with the concept of incremental costs in Ind AS 115, Revenue from Contracts with Customers.

For lessors, initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and there is no need to add them separately.

Initial Direct Costs

Definition	'Initial direct costs' are **<u>the incremental costs of obtaining a lease</u>** 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
Accounting by lessee	It is included in his initial measurement of the right-of-use asset.
Accounting by lessor	Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and there is no need to add them separately.
Note	Lessees and lessors apply the same definition of initial direct costs.

8.3.6 Discount Rates

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

<u>For a Lessee</u>

As per Ind AS 116, the Discount Rate to be used should be:

THE INTEREST RATE IMPLICIT IN THE LEASE, if that rate can be readily determined.

OR

If not, then the lessee shall use **THE LESSEE'S INCREMENTAL BORROWING RATE.**

Where,

'Interest rate implicit in the lease' is defined as the rate of interest that causes the following:

The present value of lease payments made by the lessee for the right to use the underlying asset + The unguaranteed residual value = The fair value of the underlying asset + Any initial direct costs of the lessor

Lease payments are discounted using the interest rate implicit in the lease (as above and to be calculated from the perspective of lessor) if that rate can be readily determined. But, if that rate cannot be readily determined then, the lessee uses the incremental borrowing rate.

As discussed above, the lessee's **incremental borrowing rate** is the rate of interest that

— the lessee would have to pay to borrow over a **similar term**,

— and with a **similar security**,

— the funds necessary to obtain an asset of a **similar value** to the Right of use Asset

— in a **similar economic environment**.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the ROU Asset (**NOT the underlying asset**). ***For e.g.***, in the case of a five-year property lease, the lessee considers the borrowings with a similar term to the five-year ROU Asset (and NOT the property itself), which may have a significantly longer life. Observable rates (such as a property yield) can be used as a **starting point** to determine the incremental borrowing rate but adjustments need to be considered for an asset with a value similar to the ROU Asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that, in some cases, **significant judgement** will be needed to determine the incremental borrowing rate.

As discussed above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee (i.e., payments are to be made in a foreign currency) then, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency.

For a Lessor:

Lessor to use the interest rate implicit in the lease as discussed above.

8.3.7 Economic Life

'Economic Life' is defined as either

- the period over which an asset is expected to be economically usable by one or more users or
- the number of production or similar units expected to be obtained from an asset by one or more users.

8.3.8 Fair Value

The fair value for the purposes of applying the lessor accounting requirements in Ind AS 116 is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The fair value definition for lessors has been carried forward from Ind AS 17.

Please note that for the purposes of determination of fair value under Ind AS 116, the above stated definition is to be considered, hence Ind AS 113 "Fair Value Measurement" is not applicable for determination of fair value.

8.4 LESSEE ACCOUNTING

8.4.1 Initial Recognition and Measurement

A **'lessee'** is defined as an entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.

At the commencement date, a lessee shall recognise a ROU Asset and a Lease Liability. Ind AS 116 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the ROU Asset) during the lease term for ***ALL*** leases (**except** for short-term leases and leases of low-value assets, if they choose to apply such exemptions).

Measuring the lease liability:

At the commencement date, a lessee initially measures the Lease Liability at the **present value of the remaining lease payments to be made over the lease term, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate)**. Lease payments used in measuring the lease liability are amounts due to the lessor excluding any payments that a lessee makes before lease commencement. (Refer Section 8.3.3 Lease payments).

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

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 SOFR (Secured Overnight Financing Rate) each year. At the date of commencement of the lease, SOFR is 2 per cent.

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

Solution

In the given case, the lease payments depend on a rate (i.e., SOFR) 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. SOFR) as at the commencement date. SOFR 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:

Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,104
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
			8,80,889

Therefore, the present value of lease liability initially will be measured at ₹ 8,80,889.

However, since initial payment of ₹ 1,00,000 has been paid, the lease liability to be recognised initially would be ₹ 8,80,889 – ₹ 1,00,000 = ₹ 7,80,889

*****

Measuring the right-of-use asset:

A lessee initially measures the ROU Asset at **COST**, which consists of ***ALL*** of the following:

Present Value of Lease Liability

+

Initial direct costs

+

*Estimated cost to dismantle, remove or restore, measured as per Ind AS 37

+

Prepaid lease payments (example- deposits)

−

Lease incentives received

=

Right-of use asset

Journal entry in the books of lessee

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

*On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the ROU Asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the ROU Asset to produce inventories are accounted for under Ind AS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

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?

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**

*****

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?

Solution:

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at the end of the lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

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Comparison with AS 19:

AS 19 is based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them.

- In case of finance lease, asset and liability is recognized at an amount equal to the fair value of the leased asset at the inception of the lease, unless the present value of minimum lease payments is less than the fair value.
- In case of operating lease, rentals payable is charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not

made on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit.

Hence, the accounting for leases in the books of lessee under AS 19 is completely different from that under Ind AS 116. ROU asset is not required to be accounted for under AS 19. Hence, the subsequent measurement, presentation and disclosure of ROU asset is also not relevant from AS 19 perspectives.

8.4.2 Subsequent Measurement

8.4.2.1 Right-of-use assets (ROU Asset)

After the commencement date, the right-of-use asset should be measured using a cost model, unless it applies the revaluation model as specified under Ind AS 16.

Cost model for right-of-use assets:

To follow the cost model, an entity measures a right-of-use asset at cost:

(a) Less **accumulated depreciation** and accumulated impairment losses (recognised in accordance with Ind AS 36, Impairment of Assets); and

(b) Adjusted for **re-measurements of the lease liability** specified in section 8.4.3

Depreciation for right-of-use assets

ROU Assets measured under the cost model should be depreciated in accordance with the depreciation requirements given in Ind AS 16, subject to the following:

- If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the ROU Asset reflects that the lessee will exercise a purchase option, the ROU Asset should be depreciated from the commencement date to the end of the useful life of the underlying asset;

- otherwise, the right-of-use asset should be depreciated from the commencement date to the earlier of the end of the useful life of the ROU Asset and the end of the lease term.

Where, **'useful life'** is defined as the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Therefore, if the ownership of the underlying asset transfers to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation is based on the useful life of the underlying asset. Otherwise, depreciation is determined by reference to the useful life of the right-of-use asset (provided that is not longer than the lease term).

Revaluation model for right-of-use assets:

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in Ind AS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

However, if right-of-use assets that meet the definition of investment property under Ind AS 40 "Investment Property", then, revaluation model cannot be applied because at present Ind AS 40 "Investment property" does not permit revaluation model and only cost model is allowed for all investment properties.

8.4.2.2 Lease liability:

A Lease Liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered). Lease payments reduce the lease liability when paid.

Thus, after the commencement date, a lessee shall measure the lease liability by:

a. increasing the carrying amount to reflect interest on the lease liability;

b. reducing the carrying amount to reflect the lease payments made; and

c. remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

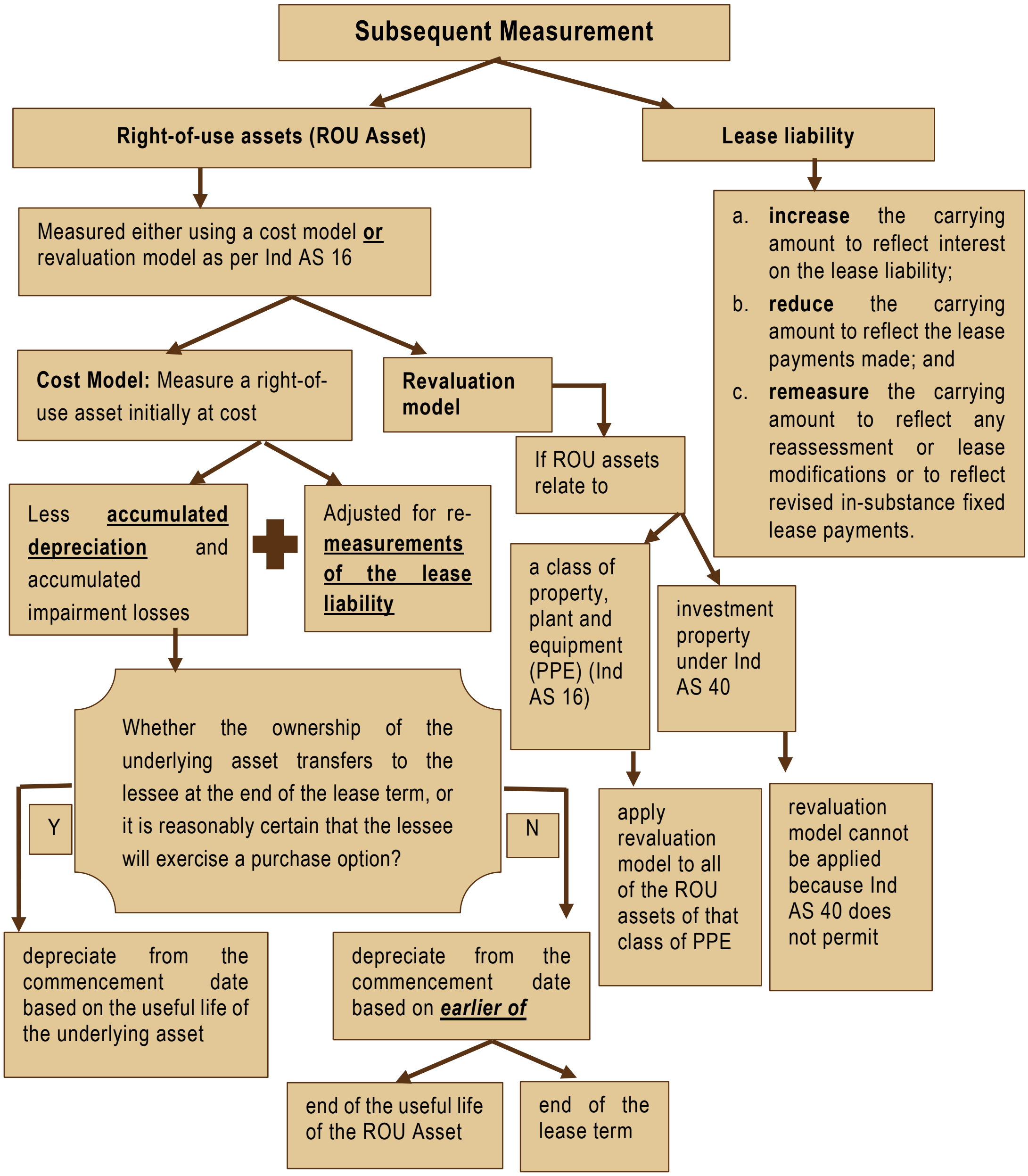
8.4.2.3 Expense recognition

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

These expenses are further explained below:

Depreciation of the ROU Asset and Interest on the Lease Liability	***Variable lease payments***	***Impairment of the ROU Asset***
After the commencement date, a lessee recognises depreciation of the ROU Asset and separately recognises interest on the lease liability. When a lessee depreciates the ROU Asset on a straight-line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Interest expense decreases as cash payments are made during the lease term and the lease liability decreases because a constant interest rate is applied to the lease liability. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the ROU Asset, results in a **<u>front-loaded expense recognition pattern</u>**.	After the commencement date, lessees recognise in profit or loss, any variable lease payments **<u>not included</u>** in the measurement of the lease liability in the period in which the event or condition that triggers those payments occur.	Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36, *Impairment of Assets*. If a lessee determines that a ROU Asset is impaired, it recognises an **<u>impairment loss</u>** and measures the ROU Asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the ROU Asset from the date of the impairment to the earlier of the end of the useful life of the ROU Asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.



Let us have a look at illustration on 'Lessee Accounting':

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?

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.

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)		
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)	-

*****

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?

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.

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.

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 x 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 x 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.

*****

8.4.2.4 Impairment of ROU Assets

Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36 *Impairment of Assets*. Ind AS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the ROU Asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

8.4.2.5 Leases denominated in a foreign currency

Lessees apply Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. Lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date, like they do for other monetary liabilities. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss.

Because the ROU Asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

This approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to the users of financial statements that the gains or losses result solely from changes in exchange rates.

8.4.3 Remeasurement

Ind AS 116 requires lessees to **REMEASURE LEASE LIABILITIES** upon a change in lease payments on account of **ANY** of the following:

- The reassessment of lease term on account of reasonable certainty to exercise/not exercise of extension and/or termination option
- The reassessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset
- In-substance fixed lease payments
- The amounts expected to be payable under residual value guarantees
- Future lease payments resulting from a change in an index or rate

When to use the 'original' and a 'revised' discount rate?

Revised Discount Rate	***Original Discount Rate***
Lessees use a **revised** discount rate when lease payments are updated for - reassessment of the lease term ***OR*** - a reassessment of a purchase option. The revised discount rate is based on the interest rate implicit in the lease for the **REMAINDER** of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.	Lessees use the **original** discount rate when lease payments are updated for - a change in expected amounts for residual value guarantees ***AND*** - payments dependent on an index or rate, **unless** the rate is a floating interest rate. - the variability of payments is resolved so that they become in-substance fixed payments.

When a lease includes a **market rate adjustment** (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (i.e., the negotiation period). ***For e.g.***, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5 but are not completed until later in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. In this example, the lessee does not adjust the lease payments at the beginning of year 6 for the expected increase in rent. Rather, any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the ROU Asset. However, if the carrying amount of the ROU Asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss.

Illustration 32- Remeasurement of a lease with variable lease payments

Entity W entered into a contract for lease of retail store with Entity J in January 1/1/20X1. The initial term of the lease is 5 years with a renewal option of a further 3 years. The annual payments for initial term and renewal term are ₹ 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 1/1/20X2 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 1/1/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 1/1/20X4 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 will 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?

Solution:

Since Entity W is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 20X4.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	**5 years; 2 years remaining in the initial term plus 3 years in the renewal period**
Entity W's incremental borrowing rate On the remeasurement date	6%
CPI available on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	₹ 1,81,840 (Refer note 1)
Lease liability immediately before the remeasurement	₹ 1,95,244 (Refer note 1)

To remeasure the lease liability, Entity W would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4.167% approx. As a result, Entity W would increase the future lease payments by 4.167%. As shown in the table, the revised lease liability is ₹ 4,91,376.

Year	**4**	**5**	**6**	**7**	**8**	**Total**
Lease payment	1,04,167	1,04,167	1,14,583	1,14,583	1,14,583	5,52,083
Discount @ 6%	1	0.943	0.890	0.840	0.792	
Present value	1,04,167	98,230	1,01,979	96,250	90,750	4,91,376

To calculate the adjustment to the lease liability, Entity W would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	4,91,376
Original lease liability	(1,95,244)
	2,96,132

Entity W would record the following journal entry to adjust the lease liability.

ROU Asset Dr.	**2,96,132**	
To Lease liability		2,96,132
Being lease liability and ROU asset adjusted on account of remeasurement.		

Working Notes:

1. Calculation of ROU asset before the date of remeasurement

Year beginning	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (A x B=C)
1	1,00,000	1.000	1,00,000
2	1,00,000	0.952	95,200
3	1,00,000	0.907	90,700
4	1,00,000	0.864	86,400
5	1,00,000	0.823	82,300
Lease liability as at commencement date			**4,54,600**

2. Calculation of Lease Liability and ROU asset at each year end

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 5%	Closing balance	Initial Value	Depreciation for 5 years	Closing balance
1	4,54,600	1,00,000	17,730	3,72,330	4,54,600	90,920	3,63,680
2	3,72,330	1,00,000	13,617	2,85,947	3,63,680	90,920	2,72,760
3	2,85,947	1,00,000	9,297	1,95,244	2,72,760	90,920	1,81,840
4	1,95,244				1,81,840		

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8.4.4 Lease Modifications

A 'lease modification' is a **change** in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

The following are examples of lease modifications that may be negotiated after the lease commencement date:

- A lease extension
- Early termination of the lease
- A change in the timing of lease payments

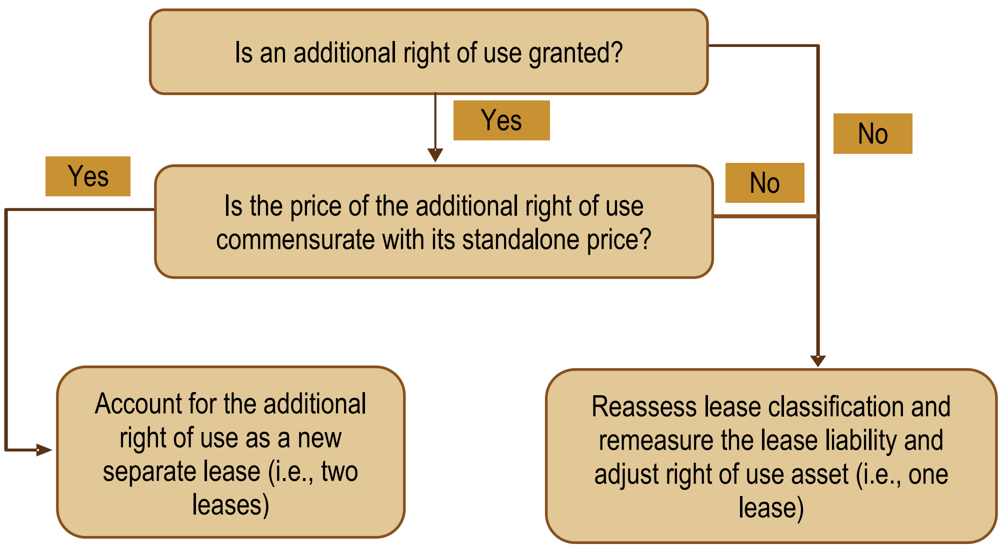
- Leasing additional space in the same building
- Surrendering a part of the underlying asset.

If a lease is modified (as stated above), the modified contract is evaluated to determine whether it is or contains a lease. If a lease continues to exist, lease modification can result in:

- A separate lease OR
- A change in the accounting for the existing lease (i.e., not a separate lease).

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are **not lease modifications but can result in the remeasurement** of Lease Liabilities and ROU Assets (Remeasurement – as discussed above).

The following diagram demonstrates Lessee's analysis of a change in a lease:



Let us understand in detail when and how the lease modification will be accounted as a separate lease contract and not as a separate lease contract:

Modification – Separate lease

A lease modification is accounted for as a separate lease if both:

a. The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**

b. The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance on the initial recognition and measurement of lease liabilities and right-of-use assets.

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 question, 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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Modification- Not Separate Lease:

If a lease modification fails the test above (e.g. additional right of use granted, but not at a standalone price) or the modification is of any other type (e.g. a decrease in scope from the original contract), the lessee must modify the initially recognised components of the lease contract.

The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:

Decrease in scope

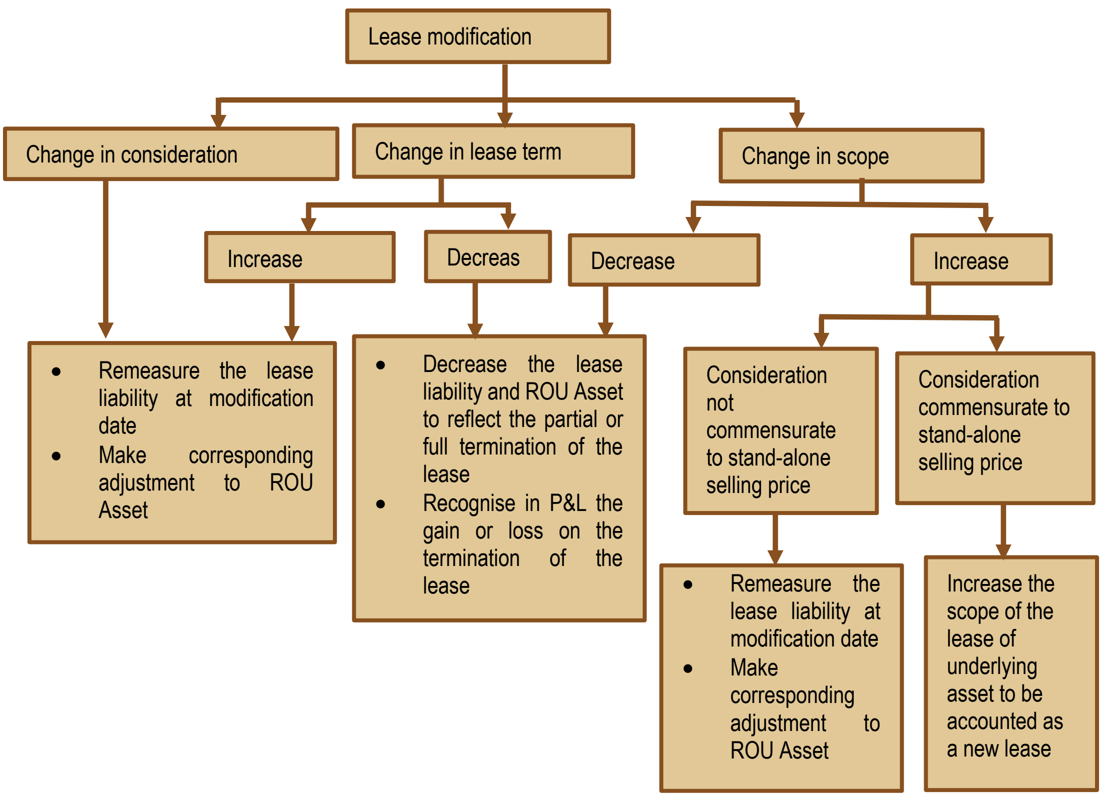
1. Remeasure lease liability using revised discount rate*(1)
2. Decrease right-of-use asset (2)
   i. by its relative scope of lease liability
   ii. compared to the original lease
3. Difference between (2i) and (2ii) recognised in P&L
4. Make a corresponding adjustment to the ROU asset

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.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.



In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). This can be understood with the help of a following example:

A lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

Scenario 1 ***(Increase in scope – Not a Separate Lease)***	***Scenario 2*** ***(Increase in scope – Separate Lease)***	***Scenario 3*** ***(Decrease in scope)***
If the modification is an increase in the scope that does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).	If the modification results in a separate lease component, the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and ROU Asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).	If the modification is a decrease in the scope, the lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and ROU Asset at the effective date of the modification (the beginning of year 8).

This can be summarised with the help of the following flow chart:

Following are some more examples for 'lease modification':

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 in the books of Lessee?

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.

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**

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 commencement date			**7,35,900**

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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Illustration 35 - Modification that 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 to be made at the end of the year (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 in the books of lessee?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 6%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 6%	d = a-b + c	e	f	g
1	3,67,950*	50,000	22,077	3,40,027	3,67,950	36,795	3,31,155
2	3,40,027	50,000	20,402	3,10,429	3,31,155	36,795	2,94,360
3	3,10,429	50,000	18,626	2,79,055	2,94,360	36,795	2,57,565
4	2,79,055	50,000	16,743	2,45,798	2,57,565	36,795	2,20,770
5	2,45,798	50,000	14,748	2,10,546	2,20,770	36,795	1,83,975
6	2,10,546				1,83,975		

*(refer note 1)

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 30,000 and

(c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment(A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	23,520
Total			**1,29,900**

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 – ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Journal Entry

Lease liability	Dr.	₹ 1,05,273	
To ROU Asset			₹ 91,987.50
To Profit and Loss			₹ 13,285.50

Lessee recognises the difference between the remaining lease liability of ₹ 1,05,273 and the modified lease liability of ₹ 1,29,900 (which equals ₹ 24,627) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Journal Entry

ROU Asset	Dr.	₹ 24,627	
To Lease liability			₹ 24,627

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment(A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	50,000	0.943	47,150
2	50,000	0.890	44,500
3	50,000	0.840	42,000
4	50,000	0.792	39,600
5	50,000	0.747	37,350
6	50,000	0.705	35,250
7	50,000	0.665	33,250
8	50,000	0.627	31,350
9	50,000	0.592	29,600
10	50,000	0.558	27,900
			3,67,950

*****

Illustration 36 - Modification that 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?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

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			

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 95,000, and

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

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825
2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	67,735
			3,89,500

Lessee recognises the difference between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an adjustment to the ROU Asset.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200
5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	55,800
Lease liability as at commencement date			**7,35,900**

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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?

Solution:

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 6%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
1	7,35,900*	44,154	(1,00,000)	6,80,054	7,35,900	(73,590)	6,62,310
2	6,80,054	40,803	(1,00,000)	6,20,857	6,62,310	(73,590)	5,88,720
3	6,20,857	37,251	(1,00,000)	5,58,108	5,88,720	(73,590)	5,15,130
4	5,58,108	33,486	(1,00,000)	4,91,594	5,15,130	(73,590)	4,41,540
5	4,91,594	29,496	(1,00,000)	4,21,090	4,41,540	(73,590)	3,67,950
6	4,21,090				3,67,950		

*Refer Note 4.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of:

(a) A three-year remaining lease term (ie. till 8th year),

(b) Annual payments of ₹ 150,000 and

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

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	1,22,400
Modified lease liability			**3,93,600**

The modified liability equals ₹ 3,93,600, of which (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 and (refer note 1) (b) ₹ 2,62,400 relates to the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3).

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950 / 5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability	Dr.	1,53,790	
To ROU Asset			1,47,180
To Gain			6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 (₹ 2,67,300 – ₹ 2,62,400*), as an adjustment to the ROU Asset.

*(Refer note 3)

Lease Liability	Dr.	4,900	
To ROU Asset			4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

ROU Asset	Dr.	1,31,200	
To Lease Liability			1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	*Lease liability*				*ROU Asset*		
	Opening balance	*Interest expense @ 7%*	*Lease payment*	*Closing balance*	*Opening balance*	*Depreciation charge*	*Closing balance*
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,070**	(1,15,690)	2,31,380
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,380	(1,15,690)	1,15,690
8	1,40,133	9,867*	(1,50,000)	-	1,15,690	(1,15,690)	-

*Difference is due to approximation; **Refer Note 5

Working Notes:

1. Calculation of lease liability on increased consideration:

Year	Lease Payments (A)	Present value @7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	40,800
Modified lease liability			**1,31,200**

2. Calculation of remaining lease liability for the original contract of 2000 square meters at original discount rate:

Year	Lease Payments (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
Remaining lease liability			**2,67,300**

3. **Calculation of remaining lease liability for the original contract of 2000 square meters at revised discount rate:**

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	81,600
Remaining lease liability			**2,62,400**

4. **Calculation of Initial value of ROU asset and lease liability:**

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 commencement date			**7,35,900**

5. **Calculation of opening balance of Modified ROU Asset at the beginning of 6th year:**

The remaining ROU Asset for the original 2,000 square metres of office space after decrease in term	2,20,770
Less: Adjustment for increase in interest rate from 6% to 7%	(4,900)
Add: Adjustment for increase in leased space	1,31,200
	3,47,070

*****

8.4.5 Presentation

ROU Assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the balance sheet. The following table depicts how lease-related amounts and activities are presented in lessees' financial statements:

Balance Sheet	***Statement of profit and loss***	***Statement of cash flows***
ROU Assets: They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property **Lease Liabilities:** They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that includes lease liabilities and their amounts	**Depreciation and Interest:** Depreciation on Right of use asset and interest expense accreted on lease liabilities are presented **separately** (i.e., they **CANNOT** be combined). This is because interest expense on the lease liability is a component of **finance costs**	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities **Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)

8.4.6 Disclosure

Disclosure objective:

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the balance sheet, statement of profit and loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of the lessee.

Ind AS 116 requires lessees to present all disclosures in:

— a single note ***OR***

— separate section in the financial statements.

Quantitative Disclosure Requirement		
Balance sheet	***Statement of Profit and Loss***	***Statement of Cash Flows***
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on Ind AS 107 requirements.	– Depreciation of assets by class. – Interest expense on lease liabilities. – Short-term leases expensed* – Low-value leases expensed* – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale and leaseback transactions.	– Total cash outflow for leases.

* These disclosures need not include leases with lease terms of one month or less.

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period.

Other disclosure requirements also include:

♦ Commitments for short-term leases if the current period expense is dissimilar to future commitments.

- For right-of-use assets that meet the definition of investment property, the disclosure requirements of Ind AS 40, *Investment property*, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of Ind AS 16, *Property, plant and equipment.*
- Entities applying the short-term and/or low-value lease exemptions are required to disclose that fact.

Qualitative Disclosure Requirements
– A summary of the nature of the entity's leasing activities;
– Potential cash outflows the entity is exposed to that are not included in the measured lease liability, including:
– Variable lease payments;
– Extension options and termination options;
– Residual value guarantees; and
– Leases not yet commenced to which the lessee is committed.
– Restrictions or covenants imposed by leases; and
– Sale and leaseback transaction information.

In providing additional information, lessees are required to consider:

(a) Whether that information is relevant to the users of the financial statements. The additional information (as specified above) is included **ONLY IF** that information is **expected to be relevant** to users of financial statements. For e.g., this is likely to be relevant if it helps those users to understand:

The flexibility provided by leases	*for e.g., a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions*
Restrictions imposed by leases	*for e.g., by requiring the lessee to maintain particular financial ratios*
Sensitivity of reported information to key variables	*for e.g., future variable lease payments*

Deviations from industry practice	*for e.g., unusual or unique lease terms and conditions that affect a lessee's lease portfolio*
Exposure to other risks arising from leases	

(b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

8.4.7 Income tax accounting

For lessees, Ind AS 116 requires recognition of lease related assets and liabilities that are not on the balance sheet under today's accounting (i.e. amounts related to leases that are operating leases under Ind AS 17) and could change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

(a) recognition and measurement of deferred tax assets and liabilities; and

(b) assessment of the recoverability of deferred tax assets.

8.5 LESSOR ACCOUNTING

8.5.1 Lease Classification

A **'lessor'** is defined as an entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

At inception, lessors classify all leases as FINANCE LEASE or OPERATING LEASE. Lease classification is very important because it determines how and when a lessor recognizes lease income and what assets are recorded. Classification is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract.

Where, a **'Finance Lease'** is defined as a **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Where, an **'Operating Lease'** is defined as a **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Classification of Lease at Inception

- Operating Lease → a **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**
- Finance Lease → a **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**

Ind AS 116 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a **FINANCE LEASE**:

Ownership
- The lease transfers owenership the asset to the lessee by the end of the lease term

Purchase option
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised

Lease term
- The lease term is for the major part of the economic life of the asset even if title is not transferred

PV of Minimum Lease Payments
- At the inception date, the present value of the lease payments amounts to at least substantially all* of the fair value of the asset

Specialised Nature
- The asset is of such a specialised nature that only the lessee can use it without major modifications

Ownership	• The lease transfers owenership the asset to the lessee by the end of the lease term
Purchase option	• The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised
Lease term	• The lease term is for the major part of the economic life of the asset even if title is not transferred
PV of Minimum Lease Payments	• At the inception date, the present value of the lease payments amounts to at least substantially all* of the fair value of the asset
Specialised Nature	• The asset is of such a specialised nature that only the lessee can use it without major modifications

*The term "substantially all" is not defined in Ind AS 116.

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

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

Other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

Lease classification test for land and buildings:

For a lease that includes both land and buildings elements, the lessor **separately assesses** the classification of each element as a finance lease or an operating lease, **having fact that land normally has an indefinite economic life**.

The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease.

For a lease of land and buildings in which the amount for the land element is **immaterial** to the lease, the lessor may treat the land and buildings as a **single unit** for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the **entire** underlying asset.

Residual value guarantees included in the lease classification test:

In evaluating Ind AS 116's lease classification criteria, lessors are required to include in the 'substantially all' test, **any (i.e., the maximum obligation) residual value guarantees** provided by both lessees and any other third party unrelated to the lessor.

Reassessment of lease classification:

Lessors are required to **reassess** the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the **effective date of the modification** using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the **same manner** as any new lease.

Key concepts applied by the lessor:

'Gross investment in the lease' is the **SUM** of:

(a) the lease payments receivable by a lessor under a finance lease; ***AND***

(b) any unguaranteed residual value accruing to the lessor.

'**Net investment in the lease'** is the gross investment in the lease discounted at the interest rate implicit in the lease.

'**Unguaranteed residual value'** is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

8.5.2 Finance Leases

8.5.2.1 Recognition

At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as receivable at an amount equal to the **net investment in the lease**.

8.5.2.2 Initial Measurement

At lease commencement, a lessor accounts for a finance lease, as follows:

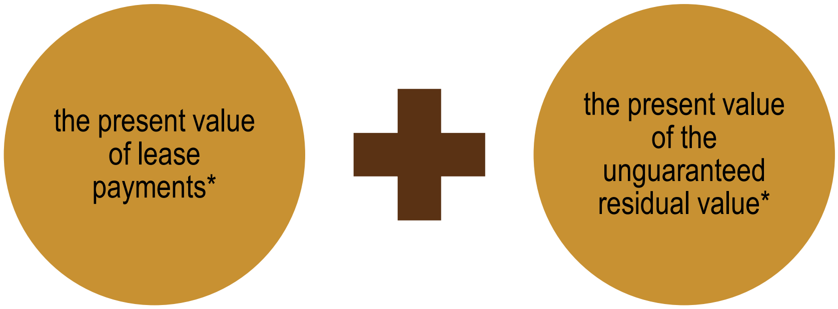
Derecognises the carrying amount of the underlying asset

Recognises the net investment in the lease

Recognises, in profit or loss, any selling profit or selling loss

For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the lease and are not added separately to the net investment in lease.

The net investment in the lease is initially measured as the sum of:



*discounted using the interest rate implicit in the lease (i.e., the discount rate).

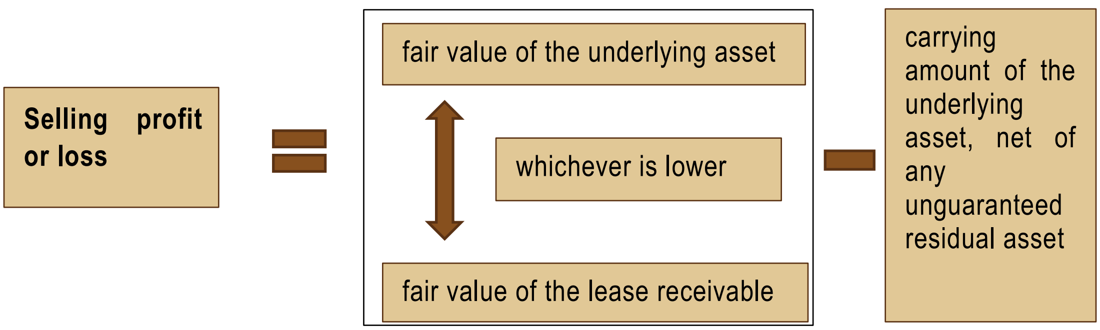
*Lease payments as described in section 8.3.3

Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

Journal entry for finance lease on initial measurement

Finance lease receivable Dr.	Net investment	
To Underlying asset		Carrying amount

(Balancing figure is profit or loss)



8.5.2.3 Initial Measurement – Manufacturer or Dealer Lessors

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.

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss on a **finance lease**, regardless of whether the lessor transfers the underlying asset as described under Ind AS 115. Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease are recognised as an expense at the commencement date and are **excluded** from the net investment in the lease because they are mainly related to earning the manufacturer or dealer's selling profit.

Accounting for initial direct costs shall be done in the following manner:

By Lessor
Finance Lease: Ind AS 116 requires 'lessors' (*other than manufacturer or dealer lessors*) to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. (*Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement*). **Operating Lease:** Ind AS 116 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

8.5.2.4 Subsequent Measurement

After lease commencement, a lessor accounts for a finance lease, as follows:

- Recognises **finance income** (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease).
  - Income is recognised on the components of the net investment in the lease, which is_Interest on the lease receivables.
- Reduces the net investment in the lease for lease payments received (net of finance income calculated above)
- Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned
- Recognises any impairment of the net investment in the lease

Remeasurement of the net investment in the lease:

After lease commencement, the net investment in a lease is **NOT REMEASURED UNLESS** in either of the following situations:

- The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of the original terms and conditions of the lease) and the modified lease is not accounted for as a separate contract

OR

- The lease term is revised when there is a change in the non-cancellable period of the lease

(Refer section 8.5.4 Modification of lease)

Summary-Accounting treatment in the books of a lessor

Particulars	Finance lease	Operating lease
Initial measurement		
Balance sheet	• Derecognise the carrying amount of the underlying asset • Recognise the net investment in the lease i.e. a finance lease receivable (equal to the	• Continue to present the underlying asset • Add any initial direct costs incurred in connection with obtaining the lease to the

	present value of the lease payments to be received)	carrying amount of the underlying asset • A **manufacturer or dealer lessor does not recognise any selling profit** on entering into an operating lease because it is not equivalent of a sale
Statement of Profit and loss	• Recognises, in profit or loss, any **<u>selling profit or selling loss</u>**	•
<u>Subsequent measurement</u>		
Balance sheet	• Reduce the net investment in the lease for lease payments received (net of finance income calculated above) • **<u>After</u>** lease commencement, the net investment in a lease is **<u>NOT REMEASURED UNLESS</u>** either: - The lease is modified and the modified lease is not accounted for as a separate contract ***OR*** - The lease term is revised when there is a change in the non-cancellable period of the lease. • Recognise any impairment of the net investment in the lease, if there has been a **<u>reduction in the estimated unguaranteed residual value</u>**	• Calculate depreciation in accordance with Ind AS 16 and Ind AS 38. • Apply Ind AS 36 to determine whether an underlying asset is impaired and to account for any impairment loss identified.

Statement of Profit and loss	• Apportion the amount received between the finance income and reduction in receivable • Finance income will be computed to give a constant periodic rate of return • Separately recognises income from variable lease payments that are not included in the net investment in the lease in the period in which that income is earned • **Revise the income allocation** over the lease term and recognise immediately any reduction in respect of amounts accrued, if there has been a **reduction in the estimated unguaranteed residual value**	• Recognise lease income over the lease term, typically on a straight line basis • Depreciation expense to be recognised related to the underlying asset • Recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) **as they are earned**.

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?

Solution:

Lessor shall classify the lease as a **FINANCE LEASE** because the sum of the present value of lease payments amounts to **substantially all** of the fair value of the underlying asset.

At lease commencement, Lessor accounts for the finance lease, as follows:

Net investment in the lease	Dr.	₹ 1,11,000[(a)]	
Cost of goods sold	Dr.	₹ 92,340[(b)]	
To Revenue			₹ 1,03,340[(c)]
To Property held for lease			₹ 1,00,000[(d)]

To record the net investment in the finance lease and derecognise the underlying asset.

(a) *The net investment in the lease consists of:*

(1) *the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1)* ***AND***

(2) *the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).*

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

(b) *Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.*

(c) *Revenue equals the lease receivable.*

(d) *The carrying amount of the underlying asset.*

At lease commencement, Lessor recognizes selling profit of ₹ 11,000 which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) ie which equals ₹ 92,340]

Year 1	**Journal entry for a finance lease**		
Cash	Dr.	₹ 15,000[(e)]	
To Net investment in the lease			₹ 3,813[(f)]
To Interest income			₹ 11,187[(g)]

(e) *Receipt of annual lease payments at the end of the year.*

(f) *Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187*

(g) *Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:*

The following table summarizes the interest income from this lease and the related amortization of the net investment over the lease term:

Year	***Annual Rental Payment***	***Annual Interest Income*** [(h)]	***Net investment at the end of the year***
Initial net investment	-	-	1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282
5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000[(i)]

(h)	*Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (initial net investment) x 10.078%.*
(i)	*The estimated residual value of the equipment at the end of the lease term.*

Working Notes:

1 Calculation of net investment in lease:

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285
6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960
9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	11,480*
			1,03,340

* Figure has been rounded off for equalization of journal entry.

2 Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

*****

Impairment of the net investment in the lease:

A lessor shall apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

8.5.3 Operating Leases

8.5.3.1 Recognition and Measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis ***OR*** another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

Lessors **subsequently** recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) **as they are earned**.

A lessor recognises costs, including depreciation, incurred in earning the lease income as an expense.

Ind AS 116 also requires lessors of operating leases to **add** initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset at lease commencement and recognise those costs as an expense over the lease term on the **same basis** as lease income.

The depreciation policy for depreciable underlying assets subject to operating leases must be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with Ind AS 16 and Ind AS 38. A lessor applies Ind AS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not equivalent of a sale.

8.5.4 Lease Modifications

A '**lease modification**' is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

8.5.4.1 Finance Lease Modification

Modification- Separate lease:

A lease modification is accounted for as a separate lease if both:

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

(b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the existing lessor guidance on initial recognition and measurement.

Modification- Not Separate lease:

If a lease modification fails the test to be considered as separate lease as mentioned above, the lessor follows the following guidance:

When a modification to a finance lease is not a separate lease, the lessor first assesses whether the lease classification would have been different if the modified terms had been effective at the inception date. If the lease would have been classified as an operating lease had the modified terms been effective at the inception date, then the lessor:

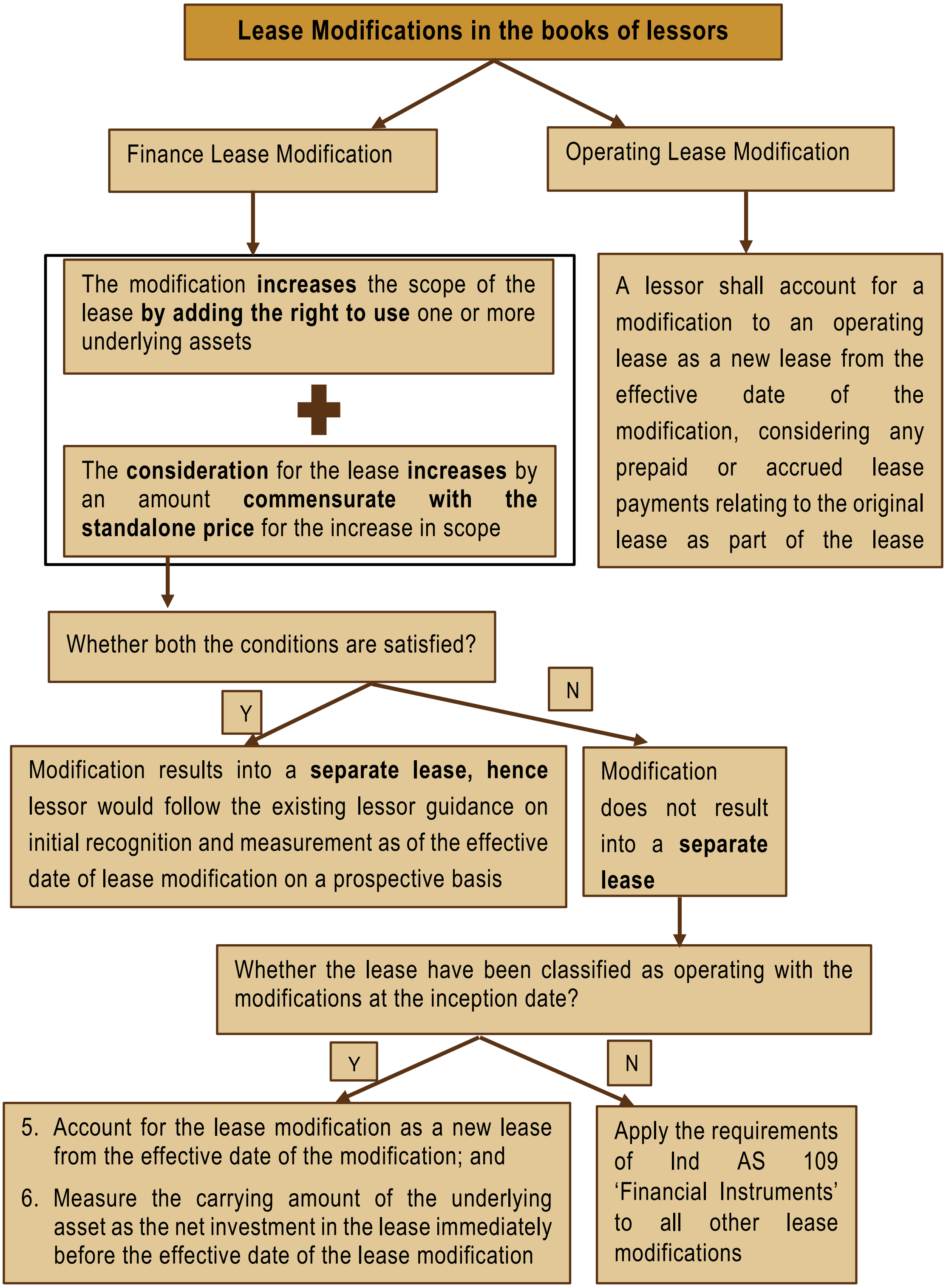
– accounts for the lease modification as a termination of the original lease and the creation of a new lease from the effective date of the modification; and

– measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

8.5.4.2 Operating Lease Modification:

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.


Lease Modifications in the books of lessors
Finance Lease Modification
Operating Lease Modification
The modification **increases** the scope of the lease **by adding the right to use** one or more underlying assets
The **consideration** for the lease **increases** by an amount **commensurate with the standalone price** for the increase in scope
A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease
Whether both the conditions are satisfied?
Y
N
Modification results into a **separate lease, hence** lessor would follow the existing lessor guidance on initial recognition and measurement as of the effective date of lease modification on a prospective basis
Modification does not result into a **separate lease**
Whether the lease have been classified as operating with the modifications at the inception date?
Y
N
5. Account for the lease modification as a new lease from the effective date of the modification; and
6. Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification
Apply the requirements of Ind AS 109 'Financial Instruments' to all other lease modifications

Comparison with AS 19:

While the accounting for leases in the books of lessor is similar under AS 19 to that under Ind AS 116, AS 19 does not provide guidance on lease modifications.

8.5.5 Presentation

Lessors have the following presentation requirements under Ind AS 116, depending on the classification of the leases:

Finance Leases	***Operating Leases***
Lessors recognise assets held under a **finance lease** in the balance sheet and present them as a receivable at an amount equal to the net investment in the lease under Ind AS 116. In addition, the net investment in the lease is subject to the **same considerations** as other assets in classification as current or non-current assets in a balance sheet.	Lessors are required to present underlying assets subject to **operating leases** according to the nature of that asset in the balance sheet under Ind AS 116.

8.5.6 Disclosure

The objective of the disclosure requirements for lessors to disclose information in the notes that together with the information provided in the balance sheet, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.

The lessor disclosure requirements in Ind AS 116 are more extensive to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor’s leasing activities.

Following are the disclosure requirements under Ind AS 116 for lessors:

Quantitative Disclosure Requirements	
Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.

Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of Ind AS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41); and – Maturity analysis of lease payments.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate to be presented.

Qualitative Disclosure Requirements
Similar to the lessee disclosure requirements, Ind AS 116 requires a lessor to disclose additional qualitative and quantitative information about its leasing activities in order to provide users with a basis for assessing the leasing's impact on the financial statements. This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including: – Buy-back agreements; – Residual value guarantees; – Variable lease payments for excess use; and – Any other risk management strategies.

8.6 OTHER MATTERS

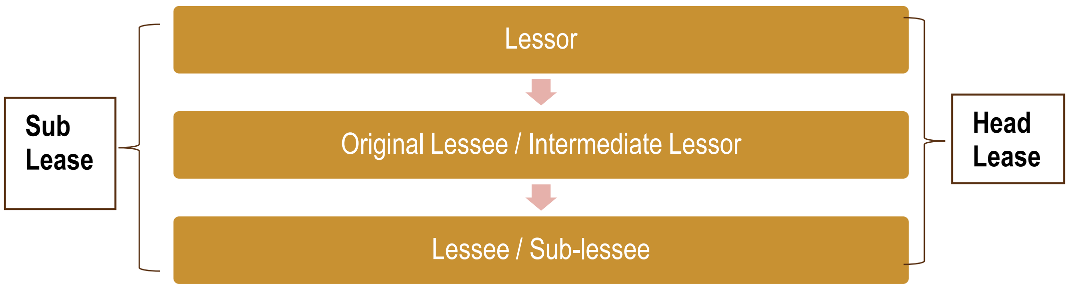
8.6.1 Sub-Leases

8.6.1.1 Recognition and Measurement

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

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect, where, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a 'head lease', the original lessee is often referred to as an 'intermediate lessor' or 'sub-lessor' and the ultimate lessee is often referred to as the 'sub-lessee'.

It can be demonstrated with the help of a following simple diagram:



In some cases, the sublease is a separate lease agreement while, in other cases, a third party assumes the original lease but, the original lessee remains the primary obligor under the original lease.

<u>Intermediate Lessor Accounting:</u>

Where an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease, i.e., the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria (as discussed earlier) BUT, it should be by reference to the 'ROU Asset' in the head lease (and NOT the 'underlying asset' of the head lease). This can be understood better with the help of a following illustration:

Illustration 39 - Classification of a sublease 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?

Solution:

The sublease is classified with reference to the 'ROU Asset' in the head lease (and **<u>NOT</u>** the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (**<u>NOT</u>**

compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

*****

The intermediate lessor accounts for the sublease as follows:

If the sublease is classified as a 'Finance Lease'	***If the sublease is classified as an 'Operating Lease'***
The original lessee derecognises the ROU Asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. The original lessee (as the intermediate lessor) recognises a net investment in the sublease and evaluates it for impairment.	The original lessee continues to account for the lease liability and ROU asset on the head lease like any other lease. If the total remaining carrying amount of the ROU asset on the head lease exceeds the anticipated sublease income, this may indicate that the ROU asset associated with the head lease is impaired (which is assessed for impairment under Ind AS 36).

In a sublease, an intermediate lessor may use the discount rate for the head lease (**adjusted for initial direct costs, if any, associated with the sublease**) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for **combining contracts** (***for e.g.***, when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a **single combined transaction**.

An intermediate lessor who subleases, or expects to sublease an asset, **CANNOT** account for the head lease as a lease of a low-value asset **even when** the required criteria w.r.t. 'leases of low-value assets' (as discussed earlier) are satisfied.

Let us consider some more examples with regards to applying the requirements of Ind AS 116 to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset:

Illustration 40 - 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?

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 three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as a finance 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).

When the intermediate lessor **enters into** a sublease, the intermediate lessor:

(i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;

(ii) recognises any difference between the ROU asset and the net investment in the sublease in profit or loss; ***AND***

(iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both

- finance income on the sublease ***AND***
- interest expense on the head lease.

*****

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).

When the intermediate lessor **enters into** the sublease, the intermediate lessor retains:

- the lease liability ***AND***
- the ROU asset

both relating to the head lease in its balance sheet.

During the term of the sublease, the intermediate lessor:

(a) recognises a depreciation charge for the ROU asset and interest on the lease liability; ***AND***

(b) recognises lease income from the sublease.

Sub-lessee Accounting:

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Ind AS 116's recognition and measurement provisions).

*****

8.6.1.2 Presentation

According to paragraph 32 of Ind AS 1, *Presentation of Financial Statements*, an entity **cannot offset** assets and liabilities or income and expenses, **unless** required or permitted by an Ind AS.

Thus, intermediate lessors are **not permitted** to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, **unless** those liabilities and assets meet the requirements in Ind AS 1 for offsetting.

Similarly, intermediate lessors are **not permitted** to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, **unless** the requirements for offsetting in Ind AS 1 are met.

8.6.1.3 Disclosure

Under Ind AS 116, entities (**including intermediate lessors**) are required to disclose **qualitative** and **quantitative** information which gives a **basis** for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor (refer the disclosures for 'lessors' and 'lessees' already discussed earlier).

8.6.2 Sale and Leaseback Transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee.

Sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing because under Ind AS 116, lessees are required to recognise most leases on the balance sheet (i.e., all leases **except** for leases of low-value assets and short-term leases depending on the lessee's accounting policy election).

Further, both the seller-lessee and the buyer-lessor are required to apply Ind AS 115 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

How to determine whether the transfer of an asset is a sale:

As discussed above, when determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor shall apply the requirements of Ind AS 115 on when an entity satisfies a performance obligation by transferring **'control'** of an asset. Thus, there are following two possibilities in this scenario:

If Control is passed	***If Control is NOT passed***
If the control of an underlying asset is **passed** to the buyer-lessor, the transaction is accounted for as a **'sale or purchase'** of the asset and a **'lease'**.	If the control of an underlying asset is **NOT passed** to the buyer-lessor, both the seller-lessee and the buyer-lessor account for the transaction as a **'financing transaction'**.

None of the indicators mentioned under Ind AS 115 individually determine whether the buyer-lessor has obtained control of the underlying asset and thus, both the seller-lessee and the buyer-lessor must consider **all relevant facts and circumstances** to determine whether control has been transferred. Further, **not all of the indicators must be present** to determine that the buyer-lessor has gained control rather, said indicators are the factors that are often present when a customer has obtained control of an asset and the said list is meant to help entities to apply the principle of control.

The existence of a leaseback, **in isolation**, does **NOT preclude a sale** because a lease is different from the sale or purchase of an underlying asset, since a lease does **not transfer 'control'** of the underlying asset. Instead, a lease **<u>transfers the 'right to control'</u>** the use of the underlying asset for the period of the lease.

However, if the seller-lessee has a **<u>'substantive repurchase option'</u>** for the underlying asset (i.e., a right to repurchase the asset), **<u>'NO sale'</u>** has occurred because the buyer-lessor has **<u>NOT</u>** obtained control of the asset.

<u>Accounting Treatment for Sale and Lease back Transaction</u>

<table>
<tr><th>Particulars</th><th>Seller-lessee</th><th>Buyer-lessor</th></tr>
<tr><td>Transfer of asset is a sale</td><td><u>Apply accounting for sale</u>
Recognise the cash received
Derecognise the underlying asset
<u>Apply ROU Accounting</u>
Apply the lessee accounting model to the leaseback asset
Measure the ROU asset at the retained portion of the previous carrying amount
Recognise a gain or loss related to the portion of the assets transferred to the buyer-lessor</td><td>Recognise the underlying asset based on the nature of the asset
Apply the lessor accounting model to leaseback asset</td></tr>
<tr><td>Transfer of asset is not a sale</td><td>Continue to recognise the underlying asset
Account for the transaction as financing transaction
Recognise a financial liability under Ind AS 109 for any amount received from the buyer-lessor
Decrease the financial liability by the payments made (as and when) less the portion considered as interest expense</td><td>Do not recognise the underlying asset
Recognise a financial asset under Ind AS 109 for any amount paid to the seller-lessee i.e. account for the amount paid as a receivable</td></tr>
</table>

Note:

- When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (**with adjustments for any off-market terms**).
- A seller-lessee recognises a lease liability and ROU asset for the leaseback (**subject to the optional exemptions** for short-term leases and leases of low-value assets).

An entity shall make the following adjustments to measure the sale proceeds at fair value if:

- the fair value of the consideration for the sale of an asset does not equal the fair value of the asset ***OR***
- the payments for the lease are not at market rates:

  (a) any **below**-market terms shall be accounted for as a prepayment of lease payments; ***AND***

  (b) any **above**-market terms shall be accounted for as an additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment ('a' or 'b' - as described above) on the basis of the following (whichever is more readily determinable):

(a) the difference between the **fair value** of the consideration for the sale and the **fair value** of the asset; ***OR***

(b) the difference between the **present value** of the contractual payments for the lease and the **present value** of payments for the lease at market rates.

The sale transaction and the resulting lease are **generally interdependent and negotiated as a package**. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the resulting lease that are above or below the market rates. These off-market terms could mislead / falsify the gain or loss on the sale and the recognition of lease expense and lease income for the lease. Thus, to ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are **NEITHER understated NOR overstated**, Ind AS 116 requires **adjustments for any off-market terms** of sale and leaseback transactions, on the **more readily determinable basis** (as discussed above). Thus, the two possibilities of the sale price ***OR*** the present value of the lease payments being 'less' or 'greater' than the fair value of the asset ***OR*** present value of the market lease payments, respectively, is discussed in detail:

When sale price or Present Value is <u>LESS</u>	***When sale price or Present Value is <u>GREATER</u>***
Using the more readily determinable basis: When the sale price is **<u>LESS</u>** than the underlying asset's fair value ***OR*** the present value of the lease payments is **<u>LESS</u>** than the present value of the market lease payments, a seller-lessee recognises the difference as an **<u>increase</u>** to the sales price and the initial measurement of the ROU asset as a **<u>'lease prepayment'</u>**.	Using the more readily determinable basis: When the sale price is **<u>GREATER</u>** than the underlying asset's fair value ***OR*** the present value of the lease payments is **<u>GREATER</u>** than the present value of the market lease payments, a seller-lessee recognises the difference as a **<u>reduction</u>** in the sales price and an **<u>'additional financing received'</u>** from the buyer-lessor.
Buyer-lessors are also required to **<u>adjust the purchase price</u>** of the underlying asset for any off-market terms. Such adjustments are recognised as: - **<u>'lease prepayments'</u>** made by the seller-lessee ***OR*** - **<u>'additional financing provided'</u>** to the seller-lessee.	

Let us consider an illustration to understand the accounting for a sale and leaseback transaction:

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?

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

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**

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor, calculated as follows:

Fair Value (at the date of sale)	(A)	27,00,000
Carrying Amount	(B)	15,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
Gain on sale of building	**(D) = (A - B)**	**12,00,000**
Relating to the right to use the building retained by Seller-lessee	(E) = [(D/A) x C]	5,30,667
Relating to the rights transferred to Buyer-lessor	(D - E)	6,69,333

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

<u>Buyer-Lessor:</u>

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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<u>Disclosures:</u>

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in Ind AS 116.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transaction separately from gains and losses on disposals of other assets under Ind AS 116. Thus, additional information relating to sale and leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in Ind AS 116, could include information that helps users of financial statements to assess, ***for e.g.***:

(a) The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions

(b) Key terms and conditions of individual sale and leaseback transactions

(c) Payments not included in the measurement of lease liabilities

(d) The cash flow effect of sale and leaseback transactions in the reporting period

8.7 TRANSITION APPROACH

An entity shall apply Ind AS 116 for annual reporting periods beginning on or after ***01 April 2019***.

For the purposes of the requirements of this 'Transition' section, the **date of initial application** is the **beginning of the annual reporting period** in which an entity first applies Ind AS 116.

Thus, Ind AS 116's transition provisions are applied at the beginning of the annual reporting period in which the entity first applies Ind AS 116 (i.e., the date of initial application). ***For e.g.***, an entity with a reporting date of 31 March 2020, applies the transition provisions on 01 April 2019.

8.7.1 Definition of a Lease

There is a practical expedient provided which permits lessees and lessors to make an election of not reassessing whether existing contracts contain a lease as defined under Ind AS 116.

Thus, if an entity elects this practical expedient, contracts that do not contain a lease under Ind AS 17 (including those under Appendix C to Ind AS 17, *Determining whether an Arrangement contains a Lease*) are not reassessed either. This practical expedient has been provided because if the entities are required to reassess existing contracts by applying the lease definition guidance in Ind AS 116, probably it would not justify the costs/complexity.

Further, if an entity chooses to apply the practical expedient, it must be applied to ***ALL*** contracts that are ongoing at the date of initial application (i.e., an entity is ***NOT*** permitted to apply the option on a lease-by-lease basis) and that fact shall also be disclosed.

8.7.2 Transition Options for Lessees

A lessee is required to apply Ind AS 116 to its leases in either of the following ways:

Full Retrospective Approach	***Modified Retrospective Approach***
Retrospectively to each prior reporting period presented, applying Ind AS 8, i.e., an entity applies Ind AS 116 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If Ind AS 116 is applied at 1 April 2019, this means that, in the 31 March 2020 financial statements, the comparative period to 31 March 2019 must be restated (assuming that this is the only comparative period presented). A restated opening balance sheet at 1 April 2018 will also need to be disclosed as required by Ind AS 1. Hence, the balance sheets for 3 period will be presented: As at 31 March 2020, 31 March 2019 & 1 April 2018.	Retrospectively with cumulative effect of initially applying Ind AS 116 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of the initial application. Therefore, restatement of comparatives is not required and only Balance Sheets for reporting date and comparative date is required to be presented.

A lessee shall apply the elected transition approach consistently to ***ALL*** leases in which it is lessee.

8.7.3 Modified Retrospective Approach

8.7.3.1 Leases Previously Classified as Operating Leases

When **applying the modified retrospective approach**, a lessee does not restate comparative figures rather, a lessee recognises the cumulative effect of initially applying Ind AS 116 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

For leases previously classified as operating leases under Ind AS 17, a lessee recognises a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the ROU asset on a **lease-by-lease basis**, at either:

— Its carrying amount as if Ind AS 116 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application (Alternative 1)

OR

— An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments (Alternative 2)

A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases (as discussed below).

A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116 – as discussed earlier).

Additionally, a lessee is also permitted to apply the following practical expedients to leases previously classified as operating leases (when applying modified retrospective approach), on a **lease-by-lease basis**:

Discount rate	• Apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
Onerous contracts	• Rely on its assessment of whether leases are onerous by applying Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets as opposed to performing an impairment review;
Short term leases	• Not recognise leases whose term ends within 12 months of the date of initial application of Ind AS 116. If this election is taken, these leases are accounted for as short-term leases;
Initial direct cost	• Exclude initial direct costs from the measurement of right-of-use assets at the date of initial application;
Hindsight	• Use hindsight, such as in determining the lease term for leases that contain options

Ind AS 116 is silent on as to how a lessee would separate and allocate lease and non-lease components of a contract upon transition when the modified retrospective approach is adopted. So, lessees could allocate the consideration in the contract (determined at lease commencement) to each lease and non-lease component on the basis of the relative stand-alone price of the lease component on that same date unless the lessee elects to use the practical expedient to account for each lease component and any associated non-lease components as a 'single lease component' (as discussed earlier).

8.7.3.2 Leases Previously Classified as Finance Leases

When applying modified retrospective approach, for leases that were classified as finance leases applying Ind AS 17, the carrying amount of the ROU asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying Ind AS 17. For such leases, a lessee shall account for the ROU asset and the lease liability applying Ind AS 116 from the date of initial application. Thus, a lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of Ind AS 116.

For leases previously classified as operating leases and finance leases, the below table summarises the application of Modified retrospective approach:

Operating Lease	Lease liability	Measure at the present value of the remaining lease payments, discounted using lessee's incremental borrowing rate at the date of initial application
	Right-of-use asset	Retrospective calculation, using a discount rate based on lessee's incremental borrowing rate at the date of initial application. or Amount of lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments relating to that lease). Lessee can choose one of the alternatives on a lease-by-lease basis.
	Lease liability	Carrying amount of the lease liability immediately before the date of initial application.

Finance Lease	Right-of-use asset	Carrying amount of the lease asset immediately before the date of initial application.
	Application of Ind AS 116	Apply the provisions of this standard to Right of Use asset and lease liability from the date of initial application.

The standard also prescribes certain practical expedients under Modified retrospective approach to leases previously classified as operating leases applying Ind AS 17.

Transition exemption on lease definition

Either

Apply the new definition to **<u>all contracts</u>**

Or

Apply practical expedients and grandfather assessment for existing contracts and apply the new definition **<u>only to new contracts</u>**

<u>Practical Expedient</u>

- This exemption must be applied either for all contracts or none **<u>i.e. cherry picking is not permitted</u>**
- This exemption does not mean that previously identified operating leases can remain off-balance sheet for lessee (unless qualify for a recognition exemption). It merely saves the entity the costs and effort of reassessing)
- If the exemption is elected, the new definition of a lease is applied only to contracts entered into or changed on or after initial application

Transition Options for Lessees

Full Retrospective approach

Restate comparatives as if Ind AS 116 always applied

Modified approach (Do not change comparative financial statements)

- Difference between asset and liability recognised in opening Retained Earnings at transition date
- Calculate present value of remaining lease payments for existing operating leases using incremental borrowing rate at date of transition
- Choose how to measure ROU asset on **lease by lease basis**

Operating lease under previous GAAP

ROU ≠ Lease liability

- Measure asset as if Ind AS 116 had been applied from lease commencement (but using incremental borrowing rate at date of transition)

ROU = Lease liability

- Measure asset at amount equal to liability (adjusted for accruals and prepayments)

Finance lease under previous GAAP

- ROU = Carrying value of previous GAAP
- Lease liability = Carrying value of previous GAAP

Note:

- A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases.
- A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116)

Let us consider an illustration to understand the transition approaches in a more precise manner:

Illustration 43 - Transition Approaches

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*

Solution:

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1 April 2017 in this case) using the incremental borrowing rate **at lease commencement date** (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Present Value Factor @12%*	*Discounted Cash flows / Present Value*
31 Mar 2018	2,00,000	0.8929	1,78,580
31 Mar 2019	2,00,000	0.7972	1,59,440
31 Mar 2020	2,00,000	0.7118	1,42,360
	6,00,000		**4,80,380**

Lease Liability Schedule:

Year	Opening	Interest Expense @ 12%	Payments	Closing
31 Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2018	4,80,380	(1,60,126)	3,20,254
31 Mar 2019	3,20,254	(1,60,127)	1,60,127
31 Mar 2020	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1 Apr 2017	4,80,380	4,80,380	-	-	-
31 Mar 2018	3,20,254	3,38,026	-	-	-
1 Apr 2018	3,20,254	3,38,026			(17,772)
31 Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
1 Apr 2019	1,60,127	1,78,589	-	-	-
31 Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-2020 is the first year of adoption and using Full retrospective method the comparative for 2018-2019 needs to be restated and 1st April 2018 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2018 (assuming that only the 2018-2019 financial information is included as comparatives).

ROU Asset	Dr.	3,20,254	
Retained Earnings	Dr.	17,772	
To Lease Liability			3,38,026
To initially recognise the lease-related asset and liability as of 1 April 2018.			

The following journal entries would be recorded during 2018-2019:

Interest expense	Dr.	40,563	
To Lease Liability			40,563
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	21,411	
To Lease Liability			21,411
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Modified Retrospective Approach (Alternative 1):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The ROU asset is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 1st April 2017 in this case) by using incremental borrowing rate as at transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @10%*	*Discounted Cash flows / Present Value*
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	*Opening Balance*	*Interest Expense @ 10%*	*Payments*	*Closing Balance*
31 Mar 2020	1,81,820	18,180	(2,00,000)	-

ROU Asset Schedule:

Year	*Opening Balance*	*Depreciation*	*Closing Balance*
31 Mar 2020	1,65,787***	(1,65,787)	-

***(Refer note no 3)

The following table shows account balances under this method beginning at lease commencement:

Date	*ROU Asset*	*Lease Liability*	*Interest Expense*	*Depreciation Expense*	*Retained Earnings*
1 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,736	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
1 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

**(Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2019.

ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,194	
To Lease Liability			18,194
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Note 1:

Calculation of Present value of lease payments as at commencement date i.e. 1st April, 2017

Year	***Payments (Cash flows)***	***Discounting Factor @10%***	***Discounted Cash flows / Present Value***
31 Mar 2018	2,00,000	0.9091	1,81,820
31 Mar 2019	2,00,000	0.8264	1,65,280
31 Mar 2020	2,00,000	0.7513	1,50,260
	6,00,000		**4,97,360**

Lease Liability Schedule:

Year	*Opening*	*Interest Expense @ 10%*	*Payments*	*Closing*
31 Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 2020	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

Calculation of ROU asset as at transition date i.e., 1st April, 2019

Year	*Opening*	*Depreciation*	*Closing*
31 Mar 2018	4,97,360	(1,65,786)	3,31,574
31 Mar 2019	3,31,574	(1,65,787)	1,65,787
31 Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 1st April 2019** (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date.

Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @ 10%*	*Discounted Cash flows / Present Value*
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	Opening	Interest Expense	Payments	Closing
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2020	1,81,820	(1,81,820)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1st Apr 2019	1,81,820	1,81,820	-	-	-
31 Mar 2020	-	-	18,182	1,81,820	-

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1st April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset	Dr.	1,81,820	
To Lease Liability			1,81,820
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,81,820	
To ROU Asset			1,81,820

To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	***Full Retrospective Approach***	***Modified Retrospective Approach (Alternative 1)***	***Modified Retrospective Approach (Alternative 2)***
Opening balance sheet impact as on 1 April 2019:			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
Period ended 31 March 2020 activity:			
Cash lease payments	2,00,000	2,00,000	2,00,000
Lease payments recognised:			
Interest expense	21,411	18,194	18,180
Depreciation expense	1,60,127	1,65,787	1,81,820
Total periodic expense	1,81,538	1,83,981	2,00,002

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8.7.4 Disclosure

Disclosure requirements vary in accordance with the Transition Approach opted. The lessee shall disclose the following as required by Ind AS 8 (except that it is impracticable to determine the amount of the adjustment):

Full Retrospective Approach	*Modified Retrospective Approach*
(a) the title of the Ind AS;	(a) the title of the Ind AS;
(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;	(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
(c) the nature of the change in accounting policy;	(c) the nature of the change in accounting policy;
(d) when applicable, a description of the transitional provisions;	(d) when applicable, a description of the transitional provisions;
(e) when applicable, the transitional provisions that might have an effect on future periods;	(e) when applicable, the transitional provisions that might have an effect on future periods;
(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment: (i) for each financial statement line item affected; and (ii) if Ind AS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;	(f) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the balance sheet at the date of initial application; and an explanation of any difference between: (i) operating lease commitments disclosed applying Ind AS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application; and (ii) lease liabilities recognised in the balance sheet at the date of initial application.
(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and	(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.	(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied. Further, if a lessee uses one or more of the practical expedients (already discussed above), it shall disclose that fact.

8.7.5 Lessors

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying Ind AS 116 from the date of initial application **except** in case of an ***'Intermediate Lessor'*** who shall:

(a) reassess subleases that were classified as operating leases applying Ind AS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying Ind AS 116. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date with reference to the ROU Asset associated with the head lease and not the underlying asset.

(b) for subleases that were classified as operating leases applying Ind AS 17 but, finance leases applying Ind AS 116, account for the sublease as a new finance lease entered into at the date of initial application. Any gain or loss arising on the sublease arrangement is included in the cumulative catch-up adjustment to retained earnings at the date of initial application.

8.7.6 Sale and Leaseback Transactions before the date of Initial Application

An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements under Ind AS 115 to be accounted for as a sale, i.e., a seller-lessee is prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with Ind AS 115.

Thus, a seller-lessee does not perform any retrospective adjustments to sale and leaseback transactions on transition to Ind AS 116. Instead, the leaseback is accounted for on transition in the following manner, depending on the classification:

Finance Lease	***Operating Lease***
If a sale and leaseback transaction was accounted for as a sale and a **finance lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application ***AND*** (b) continue to amortise any gain on sale over the lease term.	If a sale and leaseback transaction was accounted for as a sale and **operating lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; ***AND*** (b) adjust the leaseback ROU asset for any deferred gains or losses that relate to off-market terms recognised in the balance sheet immediately before the date of initial application.

8.7.7 Amounts Previously recognised in respect of Business Combinations

If a lessee previously recognised an asset or a liability applying Ind AS 103 *Business Combinations*, relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the ROU asset by a corresponding amount at the date of initial application.

8.8 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following are the extracts from the financial statements of the listed entity 'InterGlobe Aviation Limited' for the financial year 2021-2022 with respect to 'ROU Assets' and 'Lease Liabilities'.

In the Assets side of the Balance Sheet:

	Note	As at 31 March 2022
I. ASSETS		
Non-current assets		
a. Property, plant and equipment	3.a	8,225.20
b. Right of use assets	4	204,381.48

4. Right of use assets

As at 31 March 2022

Particulars	Aircraft and Engines	Equipment	Leasehold Land	Buildings	Total
Gross value - at cost					
Balance at the beginning of the year	251,021.62	5,387.87	2,944.16	2,316.50	261,670.15
Additions during the year	68,365.07	-	344.13	255.64	68,964.84
Disposals during the year	18,858.35	-	-	153.93	19,012.28
Adjustments during the year *	3,576.74	-	-	(177.70)	3,399.04
Balance at the end of the year	304,105.08	5,387.87	3,288.29	2,240.51	315,021.75
Accumulated depreciation					
Balance at the beginning of the year	80,086.41	849.55	373.28	499.20	81,808.44
Depreciation for the year**	46,647.74	636.38	268.75	291.24	47,844.11
Depreciation on disposals	18,858.35	-	-	153.93	19,012.28
Balance at the end of the year	107,875.80	1,485.93	642.03	636.51	110,640.27
Net carrying value as at 31 March 2022	196,229.28	3,901.94	2,646.26	1,604.00	204,381.48

*Includes adjustment on account of foreign currency loss, arising on re-statement of long-term foreign currency monetary loans used for acquisition of a depreciable capital asset, amounting to Rs. 398.00 (previous year foreign currency gain amounting to Rs. 417.55) and modification on leases amounting to Rs. 3,001.04 (previous year Rs. 1,669.70).

** Depreciation for the year includes Rs. 61.67 (previous year Rs. 167.26) capitalised as part of Capital work-in-progress.

In the Liabilities side of the Balance Sheet:

LIABILITIES			
Non-current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	4,161.71	3,816.28
(ia) Lease liabilities	17.b	250,586.59	202,805.34
Current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	34,805.65	21,239.95
(ia) Lease liabilities	17.b	79,224.42	70,734.97

17.b Lease liabilities

Particulars	As at 31 March 2022		As at 31 March 2021	
	Non-current	Current	Non-current	Current
Lease liabilities*	250,586.59	79,224.42	202,805.34	70,734.97
Total	250,586.59	79,224.42	202,805.34	70,734.97

The Company's leased assets primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings.

Interest expense on lease liabilities for the year is amounting to Rs. 19,627.85 (previous year Rs.16,435.04) (including interest amounting to Rs. 109.45 (previous year Rs. 238.17) capitalised under capital work-in-progress). Refer to Note 26.

Certain lease liabilities amounting to Rs. 13,155.50 (previous year Rs. 16,153.80) are secured against the respective aircraft. Remaining lease liabilities are secured to the extent of letter of credits issued / deposits given to lessors.

The Company has recognised an expense of Rs. 3,116.84 (previous year Rs. 2,804.57) on account of short term leases which represents leased aircraft and engines having a remaining lease term of less than 12 months as on transition date and other short term leases. The portfolio of other short-term leases to which the Company is committed at the end of the reporting period is not materially different from the portfolio of other short term leases for which expense has been recognised during the year.

The Company has several lease contracts that include extension and termination options. The management has included termination options in determination of lease term for contracts having such option. Extension options have not been included in determination of lease term since the management is reasonably certain not to exercise these options. Potential cash flows in relation to such extension options cannot be ascertained since the cash outflow for the extended period will depend on the negotiations with the lessors in the event of exercising the extension options.

Under certain lease arrangements of aircraft and engines, the Company incurs variable payments towards maintenance of the aircraft which are disclosed under "Supplementary rentals and aircraft repair and maintenance (net)".

The Company has entered into sale and leaseback arrangements, for certain aircraft and engines owned and controlled by the Company, to increase its liquidity. The Company has recorded proceeds of Rs. 6,006.43 (previous year Rs. 18,833.68) (net) from the sale and leaseback arrangements as disclosed in the Standalone Cash Flow Statement. The profit (net of loss) on sale and leaseback arrangements is Rs.750.96 (previous year Rs. 12.81) disclosed in Note 23.

Future cash outflows for leases not yet commenced amounts to Rs. 64,435.43 (previous year Rs. 62,343.06).

The maturity analysis of lease liabilities are disclosed in Note 29. Further, information about the Company's exposure to market risks is disclosed in Note 29.

*Includes lease liabilities with related parties amounting to Rs. 5,093.61 (previous year Rs. 5,429.29). Refer to Note 35.

ACCOUNTING POLICY

Leases

The Company's lease asset classes primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings. The Company assesses at the inception date whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

i) Lease liabilities

At the commencement date, the Company measures the lease liabilities at the present value of the lease payments that are not paid at that date. The lease liabilities include lease payments, payment of penalties for terminating the lease, if the lease term reflects the Company exercising the option to terminate, exercise price of a purchase option, if the company is reasonably certain to exercise that option, less any incentives receivable.

The lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the Company uses incremental borrowing rate (IBR). The IBR is the rate of interest that the Company would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right of use assets in a similar economic environment.

After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced by the lease payments made. In addition, the carrying amount of lease liabilities is re-measured if there is a lease modification, including modification in the lease term, lease payments or assessment of an option to purchase the underlying asset. The lease liabilities are re-measured by discounting the revised lease payments using a revised discount rate at the effective date of the modification.

ii) Right of use assets

At the commencement date, the right of use assets are measured at cost. The cost includes an amount equal to the lease liabilities plus any lease payments made before the commencement date and any initial direct costs, less any incentives received from equipment manufacturer in terms of the same lease. An estimate of costs to be incurred in respect of redelivery obligation, in accordance with the terms of the lease, is also included in the right of use assets at commencement date.

After the commencement date, the right of use assets is measured in accordance with the accounting policy for property, plant and equipment i.e. right of use assets are measured at cost, less any accumulated depreciation and impairment losses, if any. Right of use assets are also correspondingly adjusted to reflect any re-measurement impact in the lease liabilities on account of lease modification.

The right of use assets are also subject to impairment. Refer to the accounting policies in Note 2.(b) (xiv) Impairment of non-financial assets.

iii) Lease Term

At the commencement date, the Company determines the lease term which represents non-cancellable period of initial lease for which the asset is expected to be used, together with the periods covered by an option to extend or terminate the lease, if the Company is reasonably certain at the commencement date to exercise the extension or termination option.

iv) Other Leases

Lease payments associated with any other leases which falls outside the purview of Ind AS 116, short term leases and leases for which the underlying asset is of low value are charged to Standalone Statement of Profit and Loss on straight line basis over the lease term or another systematic basis which is more representative of the pattern of use of underlying asset.

v) Sale and leaseback transactions

The right of use arising from leaseback is measured at the proportion of previous carrying amount of the asset that relates to right of use retained by the Company. Where sale proceeds (net of maintenance obligation, if any) received are judged to reflect the aircraft's fair value, any gain or loss arising on disposal is recognised in the Standalone Statement of Profit and Loss, to the extent that it relates to the rights that have been transferred. Gains and losses that relate to the rights that have been retained are included in the carrying amount of the right of use assets recognised at commencement of the lease. Where sale proceeds (net of maintenance obligation, if any) received are not at the aircraft's fair value, any below market terms are recognised as a prepayment of lease payments, and above market terms are recognized as additional financing provided by the lessor.

vi) Depreciation

Depreciation on assets held as right of use assets is charged to Standalone Statement of Profit and Loss on a straight-line basis from the commencement date to the earlier of the end of the useful life of the right of use assets or the end of the lease term, except for leased aircraft previously classified as finance leases under erstwhile Ind AS where depreciation is charged on useful life of right of use assets.

Depreciation on right of use assets has been charged based on the following period:

Asset Head	***Useful life in years***
Aircraft and engines:	
— *Aircraft and engines components including spare engines*	*1-12*

— *Leased aircraft previously classified as finance lease under erstwhile Ind AS*	*20*
— *Major inspection and overhaul costs (Refer to Note 2(b) (xxi))*	*2-12*
Equipment	*8*
Leasehold land	*15-20*
Buildings	*1-10*

(Source: Annual Report 2021-2022 - 'InterGlobe Aviation Limited')

8.9 KEY DIFFERENCES BETWEEN IND AS 17 AND IND AS 116

The significant differences between Ind AS 17 (Earlier Standard on Leases) and Ind AS 116 (New Standard on Leases) are given below:

Sr. No.	***Particulars***	***Ind AS 17***	***Ind AS 116***
1	Lease Definition	A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the **right to use** an asset for an agreed period of time. Under Appendix C to Ind AS 17 *Determining whether an Arrangement contains a Lease*, it is not necessary for an arrangement to convey the right to control the use of an asset to be in scope of Ind AS 17.	A lease is a contract, or part of a contract, that conveys the **right to control** the use of an asset (the underlying asset) for a period of time in exchange for consideration. To determine if the right to control has been conveyed to the customer, an entity assesses whether, throughout the period of use, the customer has the right to obtain substantially all of the economic benefits from use of the identified asset

			and **the right to direct the use** of the identified asset.
2	Short-term lease exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases with a lease term of 12 months or less and without a purchase option. This option is available by **<u>'class of underlying asset'</u>** to which the right of use relates.
3	Leases of low-value assets exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases of low-value assets. Examples of such assets include tablets and personal computers, small items of office furniture and telephones. This option is available on a **<u>'lease-by lease'</u>** basis.
4	Lease Classification	Lessees apply a **<u>dual</u>** recognition and measurement approach for all leases. Lessees classify a lease as a 'finance lease' if it transfers substantially all the risks and rewards incidental to ownership. Otherwise a lease is classified as an 'operating lease'.	Lessees apply a **<u>single</u>** recognition and measurement approach for all leases, with options not to recognize ROU assets and lease liabilities for short-term leases and leases of low-value assets.

			There is not more classification of leases into operating and finance in case of lessees.
5	Lease Payments	At the commencement of the lease term, lessees recognize finance leases as assets and liabilities in their balance sheet at amounts equal to: a) the fair value of the leased property ***OR*** b) the present value of the minimum lease payments, whichever is **<u>lower</u>**, each determined at the inception of the lease. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee. No assets and liabilities are recognized for the initial measurement of operating leases, i.e., operating leases only impacted the statement of profit or loss.	At the commencement date, lessees measure the lease liability at the present value of the lease payments to be made over the lease term (except short-term leases and leases of low-value assets). Lease payments include: a) Fixed payments (including in-substance fixed payments), **<u>less</u>** any lease incentives receivable; b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date; c) Amounts expected to be payable by the lessee under residual value guarantees; d) The exercise price of a purchase option if the lessee is reasonably certain

			to exercise that option; e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease. In addition, the cost of the ROU asset comprises: a) The lease liability (as calculated above); b) Lease payments made at or before the commencement date, **less** any lease incentives received; c) Initial direct costs; d) Asset retirement obligations (unless those costs are incurred to produce inventories).
6	Reassessment of lease liability	Does not apply under Ind AS 17	After the commencement date, lessees are required to remeasure the lease liability when there is a lease modification (i.e., a change in the scope of a lease, ***OR*** the consideration for a lease that was not a part of the original terms and conditions of the lease)

			that is **NOT** accounted for as a separate contract. Lessees are also required to remeasure lease payments upon a change in **ANY** of the following: - The lease term; - The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset; - The amounts expected to be payable under residual value guarantees; - Future lease payments resulting from a change in an index or rate.
7	Lease income from operating leases	Ind AS 17 contains a **carve out** of not straight-lining the lease escalation, if they are in line with the expected general inflation compensating the lessor for expected inflationary cost.	There is **no such carve out** under Ind AS 116 and thus, a lessor shall recognize lease payments from operating leases as income on either a straight-line basis or another systematic basis.
8	Lease modifications to an operating lease	Ind AS 17 doesn't mention about this.	Lessors account for a modification to an operating lease as a **new lease** from the effective date of the modification

			(considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease).
9	Lease modifications which do not result in new separate leases	Ind AS 17 doesn't mention about this.	**<u>Lessees:</u>** a) Allocate the consideration in the modified contract; b) Determine the lease term of the modified lease; c) Remeasure the lease liability by discounting the revised lease payments using a revised discount rate with a corresponding adjustment to ROU asset. Additionally, lessees recognize in profit or loss any gain or loss relating to the partial or full termination of the lease. **<u>Lessors:</u>** If a lease would have been an operating lease, had the modification been in effect at the inception date, lessors in a finance lease would:

			(i) Account for the modification as a new lease; (ii) Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the modification. Otherwise, the modification is accounted for in accordance with Ind AS 109 *Financial Instruments*.
10	Presentation (Lessees) – Balance Sheet	Ind AS 17 doesn't mention about this.	**ROU Assets:** They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are

			presented as investment property **<u>Lease Liabilities:</u>** They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that include lease liabilities and their amounts.
11	Presentation (Lessees) – Statement of profit or loss	Operating lease expense is presented as a **<u>single item</u>**.	**<u>Depreciation and Interest:</u>** Lease-related depreciation and lease-related interest expense are presented **<u>separately</u>** (i.e., they **<u>CANNOT</u>** be combined). This is because interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of Ind AS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss.

12	Presentation (Lessees) – Cashflow statement	**For operating leases:** Cash payments are included within **operating activities**.	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities **Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)

13	Disclosures	Quantitative and qualitative disclosures are required but, generally **fewer** disclosures are required than those under Ind AS 116.	**Detailed** disclosures (including the format of disclosure) are required under Ind AS 116. **Additionally**, qualitative and quantitative information about leasing activities is required in order to meet the disclosure objective.
14	Sale and leaseback transactions – 'Sale'	Ind AS 17 focuses on whether the leaseback is an **operating or finance** lease.	Seller-lessees and buyer-lessors apply the requirements in Ind AS 115 to determine whether a **sale** has occurred in a sale and leaseback transaction.
15	Sale and leaseback transactions – Accounting by seller-lessees	If a sale and leaseback transaction results in a **finance lease**, any excess of sales proceeds over the carrying amount are deferred and amortized over the lease term. If a sale and leaseback transaction results in an **operating lease**, and it is clear that the transaction is established at fair value, any profit or loss is recognized immediately.	The seller-lessee measures the **ROU asset** arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of use retained by the seller-lessee and recognizes only the amount of any gain or loss that relates to the rights transferred to the buyer lessor.
16	Sale and leaseback transactions – Transactions NOT at fair value	If a sale and leaseback transaction results in an **operating lease** and the sale price is: - Below fair value: Any profit or loss is recognized	If the fair value of the consideration for the sale of an asset does **NOT** equal the fair value of the asset

		immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. <u>- Above fair value:</u> The excess over fair value is deferred and amortised over the period for which the asset is expected to be used.	***OR*** if the payments for the lease are not at market rates then, an entity is required to measure the sale proceeds at fair value with an adjustment (as appropriate) either as a prepayment of lease payments (any <u>**below**</u> market terms) ***OR*** additional financing (any <u>**above**</u> market terms).
17	Business combinations – Acquiree is a lessee	Unlike Ind AS 116, there is no exemption under Ind AS 17 for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of low value (i.e., recognition exemptions). An intangible asset is recognized if the terms of operating lease are favourable relative to market terms and a liability is recognized if terms are unfavourable relative to market terms. An intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms.	The acquirer is not required to recognize ROU assets and lease liabilities for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of a lower value (i.e., recognition exemptions). The acquirer measures the ROU asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease, relative to market terms.

8.10 KEY DIFFERENCES BETWEEN IND AS 116 AND AS 19

The significant differences between Ind AS 116 and AS 19 are given below:

Sr. No.	Particulars	Ind AS 116	AS 19
1	Lease definition	Under Ind AS 116, the definition of lease is similar to that in AS 19. But, in Ind AS 116, there is substantial change in the guidance of how to apply this definition. The changes primarily relate to the concept of 'control' used in identifying whether a contract contains a lease or not. Ind AS 116 provides detailed guidance on whether an arrangement contains a lease or whether there are non-lease / service components within the arrangement.	Under Ind AS 116, the definition of lease is similar to that in AS 19. However, guidance part given therein is different.
2	Modifications	Ind AS 116 brings in comprehensive prescription on accounting of modifications in lease contracts.	No such comprehensive coverage is there
3	Scope	Ind AS 116 has no such scope exclusion	AS 19 excludes leases of land from its scope
4	Definition	Ind AS 116 makes a distinction between 'inception of lease' and 'commencement of lease'	No such distinction has been made in AS 19
5	Classification	Ind AS 116 eliminates the requirement of classification of leases as either operating leases or finance leases for a lessee and instead, introduces a single lessee accounting model which requires lessee to recognise assets and liabilities for all leases unless it applies the recognition exemption (for leases of low value assets or short-term leases)	AS 19 requires a lessee to classify leases as either finance leases or operating leases

6	Sale & Leaseback transactions	In Ind AS 116, the approach for computation of gain/loss for a completed sale is different. The amount of gain/loss should reflect the amount that relates to the right transferred to the buyer-lessor.	As per AS 19, if a sale and leaseback transaction results in a finance lease, excess, if any, of the sale proceeds over the carrying amount shall be deferred and amortised by the seller-lessee over the lease term in proportion to depreciation of the leased asset.
		Ind AS 116 requires a seller-lessee and a buyer-lessor to use the definition of a sale as per Ind AS 115, *Revenue from Contracts with Customers* to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, then the seller-lessee shall recognise a finance liability and the buyer-lessor will recognise a financial asset to be accounted for as per the requirements of Ind AS 109, *Financial Instruments*.	AS 19 does not contain such specific requirement
7	Treatment of initial direct costs		
	Finance lease – lessor accounting		
	Non-manufacturer/ Non-dealer	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable.	Either recognised as expense immediately or allocated against the finance income over the lease term.
	Manufacturer/dealer	Same as per AS 19.	Recognised as expense immediately.

	Operating lease- Lessor accounting	Added to the carrying amount of the leased asset and recognised as expense over the lease term on the same basis as lease income.	Either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognized as expense in the period in which incurred
8	Initial direct costs	Ind AS 116 contains clearer definition of 'initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. Ind AS 116 define initial direct costs as '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.' Further, definition of the term 'interest rate implicit in the lease' has been modified in Ind AS 116.	Different guidance given
9	Presentation	As a consequence of introduction of single lease model for lessees, there are many changes in the presentation in the three components of financial statements *viz.* Balance sheet, Statement of Profit and Loss, Statement of Cash flows.	Different guidance given
10	Disclosure	There are a number of changes in the disclosure relating to qualitative aspects of leasing transactions. For eg. Entities are required to disclose the nature and risks arising from leasing transactions. Also, in case of lessor, there are changes in the disclosure of maturity analysis of leases payments receivable.	Different guidance given

8.11 MAJOR CHANGES UNDER IND AS 116 FROM IFRS 16

Ind AS 116, like other Ind AS, has been converged from the global standards, i.e., IFRS, which has been made applicable to the Indian entities (based on the net worth criteria) in a phased manner via Ministry of Corporate Affairs Roadmap. While converging from IFRS 16 (which is applicable globally from the reporting periods beginning on or after 1 January 2019), following are the carve outs given under Appendix 1 to Ind AS 116, keeping in mind, the requirements of other converged Ind AS and the economic environment in India:

S. No.	***Particulars***	***IFRS 16***	***Ind AS 116***
1	Subsequent measurement of investment property	Paragraph 34 of IFRS 16 provides that if lessee applies fair value model in IAS 40 to its investment property, it shall apply that fair value model to the ROU assets that meet the definition of investment property.	Paragraph 34 has been **deleted** under Ind AS 116 since Ind AS 40 *Investment Property* does **NOT** allow the use of fair value model. Consequently, reference of the same appearing anywhere under Ind AS 116 has also been **deleted**.
2	Interest portion of lease liability – classification in cash flow statement	Paragraph 50(b) of IFRS 16 requires classifying cash payments for interest portion of lease liability applying requirements of IAS 7 *Statement of Cash Flows*. IAS 7 provides option of treating interest paid as **operating or financing activity**.	Ind AS 7 requires interest paid to be treated as **financing activity only**. Accordingly, paragraph 50(b) has been **modified** under Ind AS 116 to specify that cash payments for interest portion of lease liability will be classified as financing activities applying Ind AS 7.

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Questions

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?

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?

3. A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. The 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?

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

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?

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 15 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?

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?

Answers

1. In this case, the rail wagons are stored at lessor's premises, and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same becomes economically beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive, and the arrangement does not contain a lease.

2. In this case, the nature of the solar plant is such that all the decisions about how and for what purpose the asset is used are predetermined because:

- – the type of output (i.e. energy) and the production location are predetermined in the agreement; and
- – when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how, and for what purpose the solar plant is used. Hence, M has a right to control the use of asset.

3. The customer has the right to direct the use of the ship because the contractual restrictions are merely protective rights that protect the company's investment in the ship and its personnel. In the scope of its right of use, the customer determines how and for what purpose the ship is used throughout the ten-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport.

The customer has the right to change these decisions throughout the period of use and hence, the contract contains a lease.

4. The observable stand-alone price for maintenance services is ₹ 2,000. There is no observable stand-alone price for the lease. Further, the insurance cost does not transfer a good or service to the lessee and therefore, it is not a separate lease component.

Thus, the Lessee allocates ₹ 8,000 (₹ 10,000 – ₹ 2,000) to the lease component.

5. After considering all the stated factors, the lessee concludes that it has a significant economic incentive to extend the lease.

Thus, for the purpose of lease accounting under Ind AS 116, the lessee uses a lease term of ten years.

6. The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

Thus, the lessee concludes that the lease term consists of 15-year non-cancellable period only.

7. The said lease contains in-substance fixed payments of ₹ 2,00,00,000 per year, which are included in the initial measurement of the lease liability under Ind AS 116.

However, the additional ₹ 2,00,00,000 that the company expects to pay per year are variable payments that do not depend on an index or rate and, thus, are not included in the initial measurement of the lease liability but, are expensed when the over-use occurs.