Educational Material on
Indian Accounting Standard (Ind AS) 116
Leases

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
NEW DELHI

This Educational Material has been formulated in accordance with the Ind AS notified by the Ministry of Corporate Affairs (MCA) as Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 and other amendments finalised and notified till March 2019.

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Foreword

The Institute of Chartered Accountants of India (ICAI) strives hard to ensure that the accounting practices in India are at par with other global economies and Indian corporates provide high quality financial reporting comparable at global level. The Ind AS Implementation Committee of ICAI has been providing guidance to the members and other stakeholders so as to enable them to implement these Standards in the same spirit in which these have been formulated.

The Ministry of Corporate Affairs (MCA) in 2019 notified Ind AS 116 which replaced Ind AS 17 which is the previous standard on leases. The new standard which has come into effect from 1st April, 2019 has changed the accounting requirements enormously for the lessee and therefore, the Ind AS Implementation Committee has brought out this Educational Material covering Ind AS 116, *Leases*. The purpose of this Educational Material is to provide guidance by way of Frequently Asked Questions (FAQs) and illustrations explaining the principles enunciated in the Standard. This publication will provide guidance to the stakeholders in accounting for various lease contracts the reporting entity enters into.

I wish to place my appreciation for CA. Nihar Niranjan Jambusaria, Chairman, Ind AS Implementation Committee as well as convenor of the Study Group, CA. Dayaniwas Sharma, Vice-Chairman and other members of the Ind AS Implementation Committee for their valuable technical contribution and cooperation in bringing out this publication.

I am sure that membership at large and other stakeholders will benefit immensely from this publication.

New Delhi — **CA. Prafulla P. Chhajed**
January 10, 2020 — ***President, ICAI***

Preface

The accounting in India has now substantially transitioned to the new set of standards, Indian Accounting Standards (Ind AS) which are converged International Financial Reporting Standards (IFRS). This set of standards has received enormous support from various stakeholders for its lucid and smooth implementation. Ind AS Implementation Committee of the Institute of Chartered Accountants of India (ICAI) is one such body which has made arduous efforts for such affluent transition to Ind AS from previous GAAP. The Committee actively engages in providing guidance to the members and other stakeholders by issuing Educational Materials on Ind AS, issuing timely clarifications on issues being faced by the members through Ind AS Technical Facilitation Group (ITFG) Clarification Bulletins, conducting Certificate Course on Ind AS, developing e-learning modules on Ind AS, workshops, seminars, awareness programmes on Ind AS and series of webcasts on Ind AS etc.

I am pleased to share that the Committee has brought out the Educational Material on Indian Accounting Standard (Ind AS) 116, *Leases*. Ind AS 116 has replaced the previously notified Ind AS 17, *Leases*. The objective of the new 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.

I may mention that the views expressed in this publication are the views of the Ind AS Implementation Committee and are not necessarily the views of the Council of the Institute. The purpose of this publication is to provide guidance for implementing this Ind AS effectively by explaining the principles enunciated in the Standard with the help of examples. However, while applying Ind AS in a practical situation, reference should be made to the full text of the Standards.

I would like to convey my sincere gratitude to the Hon'ble President, CA. Prafulla P. Chhajed and Vice-President, CA. Atul Kumar Gupta for providing this opportunity of bringing out implementation guidance on Ind AS in the form of Educational Materials. I sincerely appreciate the untiring efforts put in by the members of the Group CA. Jigar Parikh, CA.Dhinal Shah, CA. Koosai Lehery, CA. Keyur Dave, CA. Jalpa Sonchhatra, CA. Ajay Mittal, CA. Suraj Seth, CA. Dhwani Shah, CA. Saradindu Datta, CA. Narayanan Balakrishnan, CA. Rakesh Agarwal, CA. Suman Hegde and CA. Amrita Srikanth for preparing the draft of this Educational Material. I would also like to thank all the members of the Ind AS

Implementation Committee for their valuable & technical contributions in finalising this publication.

I would like to express my great appreciation to acknowledge CA. Geetanshu Bansal, Secretary, Ind AS Implementation Committee for her untiring efforts in bringing out this publication and her team CA. Prachi Jain, Executive Officer and CA. Choshal Patil for their support in bringing out this publication. I would also like to thank CA. Vidhyadhar Kulkarni, Head, Technical Directorate, for his guidance.

I am sure that, our stakeholders, particularly the preparers and auditors of financial statements, will find this Educational Material useful in the practical implementation of the Standard.

CA. Nihar Niranjan Jambusaria
Chairman
Ind AS Implementation Committee

Educational Material on Indian Accounting Standard (Ind AS) 116 *Leases*

Indian Accounting Standard (Ind AS) 116, Leases, was notified as part of the Companies (Indian Accounting Standards) (Amendment) Rules, 2019, issued by the Ministry of Corporate Affairs, Government of India, vide notification dated March 30, 2019. These Rules came into force w.e.f. April 1, 2019. Accordingly, Ind AS 116, comes into effect in respect of annual reporting periods beginning on or after 1st April, 2019.

I. Ind AS 116 – Summary

[*The purpose of this summary is to help the reader gain a broad understanding of the principal requirements of Ind AS 116 (or 'the Standard'). Reference should be made to the complete text of the Standard for a complete understanding of these requirements or in dealing with a practical situation.*]

Summary of Ind AS 116

Background

Ind AS 116 brings significant changes in accounting requirements for lease accounting, primarily for lessees. Ind AS 116 replaces the following Indian accounting standard and relevant appendix on leases:

- Ind AS 17, *Leases*
- Appendix A - Evaluating the Substance of Transactions Involving the Legal Form of a Lease
- Appendix B - Operating Leases – Incentives
- Appendix C - Determining whether an Arrangement contains a Lease

The effective date of Ind AS 116 is for annual reporting periods beginning on or after 1 April, 2019. For lessees, there is a choice of full retrospective application (i.e. restating comparatives as if Ind AS 116 had always been in force), or retrospective application without restatement of prior year comparatives. This results in the cumulative impact of adoption being recorded as an adjustment to equity at the beginning of the accounting period in which the standard is first applied (the date of initial application).

Scope

The scope of Ind AS 116 is broadly same as Ind AS 17 in that it applies to contract meeting the definition of lease except for:

a) Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

b) Leases of biological assets within the scope of Ind AS 41, *Agriculture* held by a lessee;

c) Service concession arrangements within the scope of Appendix D, *Service Concession Arrangements* of Ind AS 115, *Revenue from Contracts with Customers*;

d) Licences of intellectual property granted by a lessor within the scope of Ind AS 115, *Revenue from Contracts with Customers*; and

e) Rights held by a lessee under licensing agreements within the scope of Ind AS 38, *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in above point (e).

Recognition exemption

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

a) Short-term leases; and

b) Leases for which the underlying asset is of low value ('low value leases').

An underlying asset can be of low value only if:

(a) 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; and

(b) the underlying asset is not highly dependent on, or highly interrelated with, other assets.

Short-term lease: A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

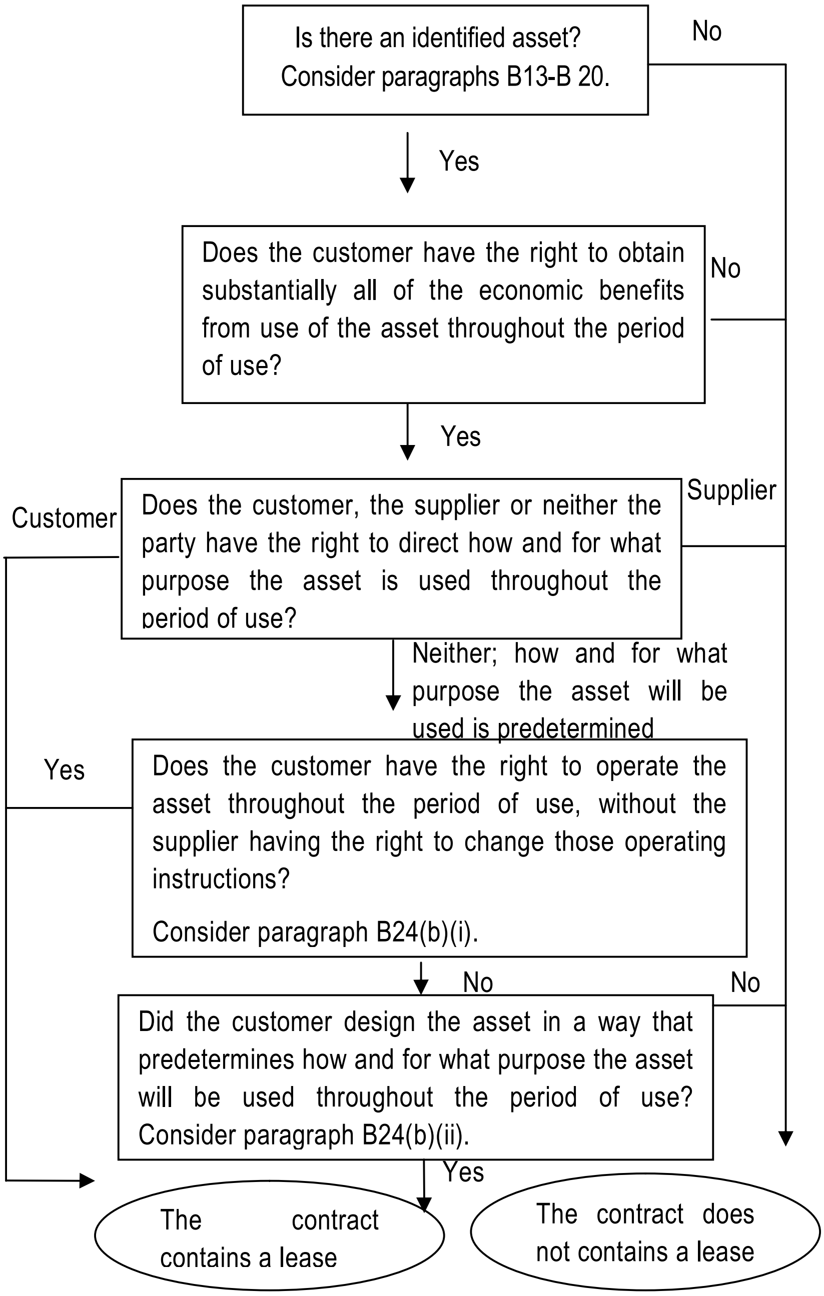
The short-term lease exemption must be applied consistently to all underlying assets in the same class. The low value lease exemption, in contrast, may be applied on a lease-by-lease basis.

If an entity applies either exemption, it must disclose that fact and certain information to make the effect of the exemption known to users of its financial statements. (Refer – Disclosure)

Identifying a lease

At inception of a contract, an entity shall assess whether the 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.

An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.


Is there an identified asset? Consider paragraphs B13-B 20.
No
Yes
Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?
No
Yes
Customer
Does the customer, the supplier or neither the party have the right to direct how and for what purpose the asset is used throughout the period of use?
Supplier
Neither; how and for what purpose the asset will be used is predetermined
Yes
Does the customer have the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions?
Consider paragraph B24(b)(i).
No
No
Did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use? Consider paragraph B24(b)(ii).
Yes
The contract contains a lease
The contract does not contains a lease

Identified assets

A contract contains a lease only if it relates to an identified asset. An asset can be either explicitly specified in a contract or implicitly specified at the time it is made available for use by the customer.

Substantive substitution rights

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use; and
- The supplier would benefit economically from the exercise of its right to substitute the asset.

Portions of assets

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, 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.

Right to obtain economic benefits from use

To determine whether a contract conveys the right to control the use of an identified asset, a company assesses whether the customer has the rights to:

- obtain substantially all of the economic benefits from use of the identified asset throughout the period of use; and
- direct the use of the identified asset.

The economic benefits from using an asset include its primary output, by-products and other economic benefits from using the asset that could be realised from a commercial transaction with a third party (e.g. subleasing the asset).

In assessing whether a customer has a right to obtain substantially all the economic benefits from the use of an identified asset, the assessment should be made based on the asset's use within the defined scope of the contract. For example:

- If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory. It does not consider what economic benefits could be obtained had there not been any geographical restriction in the contract.
- If a contract specifies that a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day. It does not consider what economic benefits could be obtained from using the machine for 24 hours a day.

Right to direct the use

A customer has the right to direct the use of an identified asset in either of the following situations:

- if the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
- if the relevant decisions about how and for what purpose the asset is used are predetermined and:
    - the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the lessor having the right to change those operating instructions; or
    - the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Separating component of contract

For a contract that contains a lease component, an entity accounts for each lease component within the contract separately from non-lease components. However, a lessee may apply a practical expedient by class of underlying asset, and ignore the requirement to separate non-lease components (such as services) from the lease components. Instead it may account for the entire contract as a single lease contract.

If this practical expedient is not used, a lessee must allocate the total contract consideration to the lease and non-lease component on the basis of their relative stand-alone prices. If standalone prices are not available, then they must be estimated.

An entity considers the right to use an underlying asset as separate lease component if it meets following criteria:

- Lessee can benefit from using that underlying asset either on its own or together with other resources that are readily available.
- Asset is neither highly dependent on nor highly inter related with the other assets in contract.

The charges incurred which are associated with lease that does not transfer good or services to lessee do not give rise to a separate component. However, they are part of total consideration that an entity allocates to the identified component.

Combination of contracts

An entity shall combine two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria are met:

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

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

c) the rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component.

Lease term

If a contract is, or contains, a lease, the lease term needs to be determined. The lease term begins on the commencement date (i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods. It comprises:

a) the non-cancellable period of the lease;

b) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

A lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

An entity shall revise the lease term if there is a change in the non-cancellable period of a lease.

Extension and termination options

At commencement date, entity should assess whether lessee is reasonably certain:

- to exercise an option to extend the lease;
- to exercise an option to purchase the underlying asset; or
- not to exercise an option to terminate the lease

In making such assessment entity considers all relevant facts and circumstances that creates 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 exercise date of option. The standard also gives examples of factors that may be considered in making such an assessment.

A lessee's past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised.

Lessee

Recognition of lease

On the commencement of the lease, lessee needs to recognise the right-of-use asset and measure it at cost. Lessee should also recognise a lease liability and measure it at the present value of the lease payments that are not paid at that date. The lease payments should be discounted using the interest rate implicit in the lease, if readily determinable or else using the lessee's incremental borrowing rate.

> Cost = Lease Liability + Lease payments made – lease incentives received + initial direct costs + estimated dismantling and restoration costs.
>
> Lease Payments = Fixed payments (including in-substance fixed lease payments) – lease incentives + variable payments + expected guaranteed residual value + exercise price of purchase option (if reasonably certain to be exercised) + penalties for termination (if reasonably certain to be terminated).

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

Subsequent measurement of right-of-use asset

Subsequently, the right-of-use asset shall be measured by applying a cost model or revaluation model if the underlying asset belongs to the class of assets to which the entity applies revaluation model as per Ind AS 16, *Property, Plant and Equipment*.

Cost model

Lessee shall measure the right-of-use asset at cost less accumulated depreciation as per Ind AS 16 and any accumulated impairment losses as per Ind AS 36.

Lessees adjust the carrying amount of the right-of-use asset for remeasurement of the lease liability, unless the carrying amount has already been reduced to zero or the change in the lease liability relates to a variable lease payment that does not depend on an index or rate.

Subsequent measurement of lease liability

After initial recognition, the lease liability is measured at amortised cost using the effective interest method and remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

Reassessment of lease liability

A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either

- there is a change in the lease term
- there is a change in the assessment of an option to purchase the underlying asset

lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.

A lessee shall remeasure the lease liability by discounting the revised lease payments, using unchanged discount rates, if either

- there is a change in the amounts expected to be payable under a residual value guarantee
- there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments

Lease modification

A lessee accounts for a lease modification as a separate lease if both of the following conditions exist:

- the modification increases the scope of the lease by adding the right-to-use one or more underlying assets; and
- the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

For a lease modification that is not a separate lease, at the effective date of the modification, the lessee accounts for the lease modification by remeasuring the lease liability using a discount rate determined at that date and:

- for lease modifications that decrease the scope of the lease, the lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, and recognises a gain or loss that reflects the proportionate decrease in scope; and

- for all other lease modifications, the lessee makes a corresponding adjustment to the right-of-use asset.

Presentation

The right-of-use assets should be either presented separately from other assets in the balance sheet or disclosed in the notes. If not presented separately, they should be presented in the appropriate line item of the balance sheet as if they were owned and disclose in the notes the line items which include such assets.

The lease liabilities should be presented either separately from other liabilities in the balance sheet or disclose in the notes the line items which include the lease liabilities.

Right-of-use assets that meet the definition of investment property are presented within investment property.

In the statement of profit and loss, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance cost that requires to be presented separately in the statement of profit and loss.

In the statement of cash flows, a lessee shall classify:

a) cash payments for the principal portion of the lease liability within financing activities;

b) cash payments for the interest portion of the lease liability within financing activities applying the requirements in Ind AS 7, *Statement of Cash Flows*, for interest paid; and

c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Lessor

Classification of leases

A lessor shall classify each of its leases as either an operating lease or a finance lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

b) the lessee has the option to purchase the underlying 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;

c) the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;

d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and

e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The above indicators are not always conclusive. If it is clear from other features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease. For example, this may be the case if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards.

Lease classification is made at the inception date and is reassessed only if there is a lease modification. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

Finance lease and Operating lease

Recognition and measurement

Particulars	Finance lease	Operating lease
Balance Sheet impact	Derecognise the underlying asset.	Continue to present the underlying asset.
	Present lease receivables at an amount equal to the net investment in lease.	Add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset.
Statement of profit and loss	Lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.	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 from the use of the underlying asset is diminished.
Statement of profit	Revenue being the fair value of the underlying	Recognise depreciation expense over the useful

and loss: In case manufacturer or dealer is lessor	asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest.	life of asset.
	The cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value.	
	Selling profit or loss in accordance with its policy for outright sales to which Ind AS 115 applies.	

A lessor initially measures a finance lease receivable at the present value of the future lease payments plus any unguaranteed residual value accruing to the lessor. The lessor discounts these amounts using the interest rate implicit in the lease.

A lessor includes the following lease payments in the measurement of the finance lease receivable:

- fixed payments (including in-substance fixed payments), less lease incentives payable;
- variable payments that depend on an index or rate;
- residual value guarantees provided to the lessor at the guaranteed amount;
- the exercise price of purchase options if the lessee is reasonably certain to exercise; and
- termination penalties payable in accordance with the expected lease term.

Manufacturer or dealer as lessor

At the commencement date, a manufacturer or dealer lessor recognises the following:

- The fair value of the underlying asset as revenue (or if lower, the present value of the lease payments discounted using a market rate of interest).
- 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. A manufacturer or dealer lessor recognises selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in Ind AS 115.

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, including:
  - Interest on the lease receivable; and
  - Interest via accretion of the unguaranteed residual asset to its expected value at the end of the lease.
- 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.

Lease modification

A lessor accounts for a modification to a finance lease as a *separate lease* if both of the following conditions exist:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

If the modification is not a separate lease, then the lessor accounts for a modification to a finance lease as follows:

- if the lease would have been classified as an operating lease if the modification had been in effect at the inception date, then the lessor:
    - accounts for the lease modification as 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; or otherwise
- otherwise, applies the requirements of Ind AS 109.

Presentation

Lessor shall present underlying assets subject to operating leases in its balance sheet according to the nature of the underlying asset.

Disclosures

The objective of the disclosures is 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.

Type of disclosure	Finance lease	Operating lease
Quantitative disclosure	Selling profit and loss	Lease income relating to variable lease payments that do not depend on an index or rate
	Finance income on the	Other lease income

	net investment in the lease	
	Lease income relating to variable lease payments not included in the net investment in the lease	Detailed maturity analysis of the lease payments receivable
	Significant changes in the carrying amount of the net investment in the lease	If applicable, disclosures in accordance with Ind AS 16 (separately from other assets), Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41.
Qualitative disclosures	Significant changes in the carrying amount of the net investment in the lease	
	A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed	

	residual value.	

Sublease

A lessee may become an intermediate lessor if it subleases an asset leased from another lessor (the 'head lessor'). An intermediate lessor classifies the sublease as a finance lease or as an operating lease with reference to the right-of-use asset arising from the head lease. That is, the intermediate lessor treats the right-of-use asset as the underlying asset in the sublease, not the underlying asset that it leases from the head lessor.

At the commencement date of the sublease, if the intermediate lessor cannot readily determine the interest rate implicit in the sublease, then it uses the discount rate that it uses for the head lease to account for the sublease, adjusted for any initial direct costs associated with the sublease.

However, if the head lease is a short-term lease for which the company, as a lessee, has elected the short-term lease exemption, then as an intermediate lessor the company classifies the sublease as an operating lease.

Sale and leaseback transactions

In a sale-and-leaseback transaction, an entity (seller-lessee) sells an asset to another entity (buyer-lessor) who then leases it back to the seller-lessee.

In order to determine the appropriate accounting treatment under Ind AS 116, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of Ind AS 115, *Revenue from Contracts with Customers.*

If the transfer of an asset by the seller-lessee satisfies the requirements of Ind AS 115 to be accounted for as a sale of the asset:

a) the seller-lessee shall measure the right-of-use asset arising from the leaseback transaction at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

Adjustments are required if consideration for the sale is not at fair value and/or payments for the lease are not at market rates. These adjustments result in recognition of:

- Prepayment to reflect below-market terms.
- Additional financing provided by the buyer-lessor to the seller-lessee to reflect above-market terms.

If the transfer of an asset by the seller-lessee does not satisfy the requirements of Ind AS 115 to be accounted for as a sale of the asset:

a) the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying Ind AS 109.

b) the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying Ind AS 109.

Sublease on transition

- At the date of initial application, an intermediate lessor reassesses ongoing subleases that were classified as operating leases under Ind AS 17 to determine whether each sublease should be classified as an operating lease or a finance lease under Ind AS 116. This assessment is made on the basis of the remaining contractual terms and conditions of the head lease and sublease.
- For subleases classified as operating leases under Ind AS 17 but finance leases under Ind AS 116, a lessor accounts for the sublease as a new finance lease entered into at the date of initial application.

Transition date accounting

Definition of lease

On transition to Ind AS 116, companies can choose whether to:

- apply the new definition of a lease to all of their contracts; or
- not to apply to contracts that were not previously identified as containing lease applying Ind AS 17.

Transition accounting: In the books of Lessee

A lessee is permitted to:

- Adopt the standard retrospectively. This approach results in an entity applying Ind AS 116 to all periods presented as if it had always been applied. Application of the full retrospective approach requires presentation of a third balance sheet in accordance with Ind AS 1, *Presentation of Financial Statements*.

  or

- Follow a modified retrospective approach. The modified approach does not require restatement of comparative periods. Instead the cumulative impact of applying Ind AS 116 is accounted for as an adjustment to equity at the start of the current accounting period in which it is first applied, known as the 'date of initial application'.

A lessee applies this election consistently to all of its leases:

Operating lease	Lease liability	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.)
Finance lease	Lease liability	Carrying amount of the lease liability immediately before the date of initial application.
	Right-of-use	Carrying amount of the lease asset immediately before the date of initial

	asset	application.

Modified retrospective approach: Practical expedient for operating lease

In applying the modified retrospective approach, several practical expedients are available for leases that were previously categorised as operating leases under Ind AS 17. On a lease-by-lease basis, a lessee may:

a) Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.

b) Rely on its assessment of whether a lease is onerous by applying Ind AS 37 immediately before the date of initial application, as an alternative to performing an impairment review. If this is chosen, then right of use asset should be adjusted by amount of any provisions for onerous leases recognized before the date of transition.

c) Not recognise leases whose term ends within 12 months of the date of initial application (use short-term lease accounting).

d) Exclude initial direct costs from the measurement of ROU assets at the date of initial application.

e) Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Transition accounting: In the books of Lessor

Except for subleases and sale-and-leaseback transactions, a lessor does not make any adjustments on transition:

Sales and leaseback transaction:

For a sale-and-leaseback transaction accounted for as a sale and finance lease in accordance with Ind AS 17, the seller-lessee:

- accounts for the leaseback in the same way as for any finance lease that exists at the date of initial application; and
- continues to amortise any gain on the sale over the lease term.

For a sale-and-leaseback transaction accounted for as a sale and operating lease in accordance with Ind AS 17, the seller-lessee:

- accounts for the leaseback in the same way as for any other operating lease that exists at the date of initial application; and

- adjusts the leaseback right-of-use asset for any deferred gains or losses that relate to off-market terms recognised in the statement of financial position immediately before the date of initial application.

Amount previously recognised in respect of business combination

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 right-of-use asset by a corresponding amount at the date of initial application.

II. Frequently Asked Questions

(These FAQs are meant only to illustrate various requirement of Ind AS 116. It may be emphasised that where the facts and circumstances are different from those described in the relevant FAQ, the response as given herein may not hold valid.)

Scope

Question 1:

Whether the following rights obtained by Entity X would be within the scope of Ind AS 116?

(a) Rights to explore for oil and use oil from an oilfield Y for 25 years

(b) Rights to access the land which contains the oil ("surface lease")

(c) Right to lay down water pipelines over the surface of the land adjacent to the land which contains oil field. Entity X requires water in the oil extraction process).

Response

Paragraph 3 of Ind AS 116, *Leases* states as follows:

"An entity shall apply this Standard to all leases, including leases of right-of-use assets in a sublease, except for:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

(b) ….."

Paragraph 3 of Ind AS 16, *Property, Plant and Equipment, inter alia,* states as follows:

"This Standard does not apply to:

(a) ……

(c) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)–(d)."

The following position emerges on a combined reading of Ind AS 116 and Ind AS 16.

Cases (a) and (b)

The words "*leases to explore for or use minerals, oils*..." include only those leases that provide the right to explore and/or extract oil (i.e. (a) and (b) above). To get access to the actual area where the oil may lie, entities may have to enter into another lease for the surface of that area. The lease for the surface of the area gives entity the right, for example, drill a well to get access to oil that lies within.

In view of the above, rights obtained under (a) and (b) above would not get covered under Ind AS 116.

Case (c)

The assets used in development or maintenance of mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources are covered under Ind AS 16 and the rights to explore for or use of such assets are covered under Ind AS 116.

Thus, the purpose of land adjacent to the oil field ((c) above) is to transport water to be used in the extraction process. The lease under (c) relates to the process of the extraction of oil rather than providing right of exploration for, or the right of extraction or use of, the oil. Accordingly, it is not covered by the scope exclusion in paragraph 3(a) of Ind AS 116 and the standard therefore applies to this lease.

Question 2

Entity X, a private sector entity, enters into a contract with the Transport Ministry (the grantor) of Country S to acquire the right to operate the civil air navigation system in Country S. Under this contract:

- the grantor provides the air navigation system;
- X is required to upgrade the system;
- X will charge users based on rates negotiated directly by it with individual users;
- there is no price-cap mechanism imposed by the grantor; and
- the contract is for a period of 10 years.

Whether the contract would be within the scope of Ind AS 116?

Response

Paragraph 3 of Ind AS 116 *inter-alia* states as follows:

"An entity shall apply this Standard to all leases, including leases of right-of-use assets in a sublease, except for:

(a) ……

(c) service concession arrangements within the scope of Appendix D, *Service Concession Arrangements*, of Ind AS 115, *Revenue from Contracts with Customers*;…."

Further paragraph 5 of Appendix D to Ind AS 115 states as follows:

"This Appendix applies to public-to-private service concession arrangements if:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls—through ownership, beneficial entitlement or otherwise—*any significant residual interest in the infrastructure at the end of the term of the arrangement.*"[Emphasis added]

If either of the above conditions is not met, the Appendix D to Ind AS 115 does not apply.

Paragraph 2 of Appendix D *Service Concession Arrangements* of Ind AS 115, *Revenue from Contracts with Customers*, inter alia states that, "an arrangement within the scope of this Appendix typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement."

In the given case, the arrangement has many characteristics of a public-to-private service concession arrangement - e.g. the grantor is a public sector body, the operator is a private sector body, the operator is responsible for the upgrade and operation of the service concession infrastructure and the infrastructure is used pursuant to public policy. However, under the terms of the contract the grantor does not control prices. Therefore, the contract is not in the scope of Appendix D of Ind AS 115 and the right to use the air navigation system would be within the scope of Ind AS 116.

Question 3

Operator X enters into a service concession arrangement, with Grantor G to operate a rail service for 15 years. The arrangement is considered to be in the scope of Appendix D, *Service Concession Arrangements*, of Ind AS 115, *Revenue from Contracts with Customers*. X enters into a contract with Entity Y (lessor) to lease the infrastructure, i.e. rolling stock to operate the rail service. The useful life of rolling stock is 25 years. X has the obligation to pay the lessor. During the concession period, G controls the services that X delivers by setting the timetable to which the rolling stock must be operated and regulates the price that X charges passengers. At the end of the concession, G has an option to acquire the rolling stock or to otherwise direct its use.

Whether the contract of Operator X with Entity Y would be within the scope of Ind AS 116?

Response

Paragraphs 7 and 11 of Appendix D of Ind AS 115, *inter-alia*, states as follows:

"7 This Appendix applies to both:

(a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and

(b) …..".

"11 Infrastructure within the scope of this Appendix shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract."

According to the above, if an arrangement is determined to be within the scope of Appendix D to Ind AS 115, the grantor, rather than the operator, controls the right to use any leased infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement.

In the given case, as the arrangement is a service concession arrangement falling within the scope of Appendix D to Ind AS 115, Operator X does not have the right to control the use of the infrastructure, i.e., rolling stock. Hence, Operator X's arrangement with Entity Y does not meet the definition of 'lease' from its perspective. Accordingly, Operator X does not apply Ind AS 116 to account for the said arrangement.

Question 4

Case I

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

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

Case II

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

Case III

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

Response

Paragraph 9, B9, B13 and B14 of Ind AS 116 state the following:

> "9 At inception of a contract, an entity shall assess whether the 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."[Emphasis added]
>
> "B9 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."
>
> "B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."
>
> "B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:
>
> (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
>
> (b) 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)."

Paragraph B20 of Ind AS 116 which provides guidance regarding identified asset in case of portion of assets states as follows:

"A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, 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."

Paragraph B21 of Ind AS 116, *inter alia*, states that, "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 asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or subleasing the asset."

Further, paragraph B24 of Ind AS 116 provides that a customer has the right to direct the use of an identified asset throughout the period of use if the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

Paragraph B25 of Ind AS 116 states the following:

> "B25 A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract."

Case I

Scenario 1:

(i) As per paragraph B13 of Ind AS 116, 'Last mile' which is a dedicated cable is an identified asset since it is physically distinct.

(ii) There are no substantive substitution rights with Entity Y, as it does not have the practical ability to substitute alternative assets throughout the period of use.

Thus, this arrangement is within the scope of Ind AS 116.

Scenario 2:

If Entity Y has the practical ability to replace the lines and it would benefit from such replacement, Entity Y has substantive substitution rights. In such case, this arrangement for the 'last mile cable' will not be within the scope of Ind AS 116.

Case II

The fibers are specified in the contract and are physically distinct. Hence, in accordance with paragraph B13 and B20, the said three fibers are identified asset.

Paragraph B18, *inter alia*, states that, "the supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset."

Further, paragraph B27 provides that although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and can actually be dependent on the decisions about how and for what purpose the asset is used.

In accordance with the above, as Entity Y can substitute these three distinct fibers only for reasons of repairs, maintenance or malfunction, it does not preclude them from being an identified asset.

Further, the Customer X has right to control the use of the identified fibers for 10 year since it has -

(a) the right to obtain substantially all of the economic benefits from use of the identified fibers throughout the period of use, i.e., 10 years; and

(b) the right to direct the use of the fibers as it makes the decisions about the use of the fibers, i.e., it has right to direct how and for what purpose the fibers are used throughout the period of use.

Hence, this arrangement is within the scope of Ind AS 116.

Case III

Paragraph B20 specifically provides that a capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber 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. In the given case, the capacity portion that will be provided to Customer X is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable, thus, it is not an identified asset. Further, Entity Y makes all decisions about the transmission of data, (i.e., supplier lights the fibers, makes decisions about which fibers are used to transmit customer's traffic).

Thus, the contract does not contain a lease and is therefore not within the scope of Ind AS 116.

Question 5

Entity X (lessee) manufactures phone handsets. X enters into a 10-year lease contract with Entity Y (lessor) of a non-specialised machine to be used in manufacturing parts for phone A1. It expects this model of phone to remain popular with customers until it completes development and testing of an upgraded model - phone A2, which is expected to be launched in the near future, i.e., within one year. The current machine can be easily replaced and the cost to install it in X's manufacturing facility is not significant. X and Y each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date. The lease agreement does not provide any purchase option in respect of the leased asset to Entity X.

Whether the recognition exemption for 'short term leases' as per paragraph 5 of Ind AS 116 is available to Entity X?

Would the answer be different, if the development and testing of the upgraded model is expected to be completed in three years rather than one year?

Response

Ind AS 116 (or 'the standard') defines the terms 'lease term' and 'short-term lease' as follows:

> ***Lease term***
>
> "The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:
>
> (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
>
> (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."
>
> ***Short-term lease***
>
> "A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease."

Paragraph B34 of Ind AS 116 states as follows:

> "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 lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty."* [Emphasis added]

Further paragraph B37 of Ind AS 116 provides as follows:

> "At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers 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."

In view of the above, although the contract in the given case is for 10 years, the non-cancellable period is one year because, both X and Y have termination rights without a penalty and the cost to replace and install the machine in X's manufacturing facility is not significant. As a result, the lease term is one year and the lease qualifies for the short-term lease exemption.

Even if the development and testing of the upgraded model is expected to be completed in three years rather than one year, the non-cancellable period is still one year since Entity X and Entity Y have a right to terminate the arrangement without penalty and the machines can be easily replaced by Entity X without incurring any significant cost. Hence, even in such a case, the lease qualifies for short term lease exemption.

Question 6

As per paragraph 8 of Ind AS 116, the election of exemption of short term application, the election for short-term leases shall be made by class of underlying asset to which the right of use relates.

Whether the classes of underlying assets for the purpose of Ind AS 116 would be similar to those as specified in Ind AS 16, *Property, Plant and Equipment* or Ind AS 38, *Intangible Assets* as applicable?

Response

Paragraph 8 of Ind AS 116, *inter alia*, states that, "a class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations."

Paragraph 37 of Ind AS 16 states as follows:

"A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations.

The following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures;

(h) office equipment; and

(i) bearer plants."

Paragraph 119 of Ind AS 38, *Intangible Assets*, *inter alia*, states as follows:

"A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements."

It is noted that all the three standards essentially define a class of assets as 'a grouping of assets of a similar nature and use in an entity's operations'. Accordingly, it would be appropriate to classify the right-of-use assets along the lines of Ind AS 16 or Ind AS 38 as appropriate. However, it may be noted that the above are only examples of classes of assets and as per Schedule III entities may have different classes subject to criteria of similar nature and use is met.

Question 7

Entity X (CNG provider to customers) enters into an arrangement with Entity Y (a gas storage facility provider) and obtains the right to store its gas in a specified gas storage reservoir that has no distinct compartments. At inception of the contract, Entity X has storage rights that permit it to use up to 55% of the capacity of the gas storage reservoir throughout the term of the contract. Entity Y can use the remaining 45% capacity of the storage reservoir as it considers appropriate, e.g., by allowing other parties to store the gas.

Whether the capacity portion used by Entity X meets the criterion of an identified asset?

Response

Paragraphs B13 and B20 of Ind AS 116 state as follows:

> "B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."
>
> "B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber 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."

In the given case, Entity X only has right to use upto 55% of the storage reservoir's capacity. The capacity portion used by Entity X is neither physically distinct from the remainder of the reservoir nor does it represent substantially all of the reservoir's capacity. Thus, in the given case, the capacity portion of Entity X does not meet the criterion of being an identified asset.

Question 8

Entity X, a garment manufacturer enters into an arrangement with a warehouse facility Y for the right to store the ready garments in a specified storage warehouse. The warehouse has twenty rooms serially numbered and the rooms one to eleven are contractually allocated to Entity X with exclusive right to use. Y does not have substitution rights. The storage space which is allocated to Entity X represents the 55% of the total storage capacity of Y.

Whether the storage space (capacity portion) used by Entity X meets the criterion of an identified asset?

Response

Paragraphs B13 and B20 of Ind AS 116 state:

> "B13 An asset is typically identified by being explicitly specified in a

contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."

"B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber 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."

In accordance with above paragraph, capacity portion of an asset must be physically distinct to meet the criteria for an identified asset.

In the given case, although only 55% of storage space is used by Entity X but it meets the criterion for an identified asset as the storage space allocated, i.e., rooms are explicitly specified in the contract and physically distinct from the other storage locations within the warehouse. Further, Y has no substitution rights.

Question 9

Entity X (PNG provider) enters into an arrangement for 15 years with Entity Y for using 60 % of the capacity of a gas pipeline. The quantity of gas which is to be sent in the pipeline is decided by Entity X. Entity Y makes all decisions regarding operation and maintenance of the pipeline. Entity X pays a fixed capacity charge per month and a variable amount which depends on the quantity of gas transported. Entity Y may allow third parties to use the remaining unused 40 % capacity only if Entity X refuses to utilise the same, i.e., Entity X has the right of first refusal.

Whether the pipeline meets the criterion of an identified asset?

Response

Paragraphs B13 and B20 of Ind AS 116 state as follows:

"B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."

"B20 A capacity portion of an asset is an identified asset if it is

> physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber 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."

In accordance with above paragraph, if the capacity portion of an identified asset which is not physically distinct represents substantially all of the capacity then it meets the criterion for an identified asset.

Whether the 'right of first refusal' over capacity be considered when evaluating the 'substantially all' criterion depends on the facts of the particular case.

In the given case, Entity X uses 60 % of the capacity and has the right of first refusal for all of the remaining 40 % capacity. Therefore, the pipeline meets the condition of being an identified asset unless the 'right of first refusal' is not substantive, e.g., if there are certain conditions due to which there is no realistic possibility that Entity X would purchase the additional capacity (for example Entity X is required to pay an exorbitant amount to use the additional 40 % of capacity).

Question 10

Entity X enters into a contract for a period of ten years with a logistics company, Entity Y, for use of the latter's trucks. As per the contract terms, Entity Y has a large pool of similar trucks, any one or more of which can be used to fulfil the requirements of the contract. Entity Y provides trucks and drivers as part of the contract.

Whether the arrangement contains a lease of trucks?

Response:

Paragraph B13 of Ind AS 116 states the following:-

> "B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."

In the given case, trucks are not identified explicitly or implicitly and hence the arrangement does not contain a lease.

Question 11

Entity X (Customer) enters into a contract with Entity Y (Supplier) for a period of ten years for the right to use a vehicle. The vehicle is explicitly specified in the contract. Whether Entity Y has substantive substitution rights in each of the following scenarios?

Scenario 1: Entity Y has no substitution rights for first four years from the commencement of the contract. However after four years, Entity Y can substitute the vehicle at any time.

Scenario 2: Entity Y has a right to substitute the vehicle only on the occurrence of a particular event, i.e., in case of breakdown of the vehicle.

Response

Paragraph B15 of Ind AS 116 states as follows:

"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". [Emphasis added]

Scenario 1:

Entity Y has right to substitute the asset after four years of commencement of the contract. The substitution right is not substantive because Entity Y does not have the practical ability to substitute alternative assets throughout the period of use.

Scenario 2:

Entity Y has right to substitute the asset only in case of breakdown of the vehicle. The substitution right is not substantive because Entity Y does not have the practical ability to substitute alternative assets throughout the period of use.

Question 12

A club enters into an arrangement to have an exclusive right to use a specific auditorium every Saturday and Sunday for a five year period to screen movies for its members. During rest of the week, the owner of the auditorium can use it for any other purpose.

Whether the said contract meets the definition of lease?

Response

Ind AS 116 defines the terms 'lease' and 'lease term' as follows:

Lease

"A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."

Lease term

"The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

(a) ...."

In accordance with the above, an arrangement to use an identified asset would meet the definition of a lease if it conveys the right to use an asset for a non- cancellable period of time. There is no requirement in the Standard for the non-cancellable period to be continuous. Accordingly, an arrangement that provides right to control the use of an identified asset would meet the definition of a lease even if it contains intermittent periods during which the customer does not have the right to control the use of the asset.

In the given case, the period of use consists of non-consecutive days as club can use the auditorium for every Saturday and Sunday over the five year contract period. The use of the same auditorium by the owner during the remaining days of the week throughout the five year period does not prevent the contract from being a lease.

Question 13

Entity Y owns a large shopping centre. Customer X enters into a contract to lease a specified retail space for five years. Under the contract, Entity Y can require X to relocate to another retail space within the shopping centre. Entity Y would need to pay for costs of relocation and provide X with another space of similar attributes. Entity Y would only benefit economically from relocating X if a major new tenant were to move in, taking up a large amount of space at a sufficiently higher rate than the existing tenants. Although it is possible that those circumstances may arise, at inception of the contract, it is not likely that those circumstances will arise.

Whether Entity Y has substantive substitution rights?

Response

Paragraph B13 and B14 of Ind AS 116 state the following:

> "B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer."
>
> "B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:
>
> (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
>
> (b) 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)."

Paragraph B16 of Ind AS 116, *inter alia,* states that, "an entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that at inception of the contract are not considered likely to occur. Examples of future events that, at inception of the contract would not be considered likely to occur and thus should be excluded from evaluation include: (a) an agreement by a future customer to pay an above market rate for use of the asset."

Even though Entity Y has the practical ability to substitute the retail unit, it could benefit economically from substitution only in specific circumstances. At inception of the contract those circumstances are not considered likely to arise. Therefore, as per the paragraph B16 of the standard, Entity Y's substitution right is not substantive.

Question 14

Entity X, a utility company enters into a contract for twenty years with Entity Y, a power company, to purchase all of the electricity produced by a new solar power station. The solar power station is explicitly specified in the contract and PQR has no substitution rights. Entity Y owns the solar power station and will receive tax credits relating to the construction and ownership of the solar power station, and Entity X will receive renewable energy credits that accrue from use of the solar power station.

Whether Entity X has the right to obtain substantially all of the economic benefits from the solar power station during the period of arrangement?

Response

Paragraphs B21 of Ind AS 116 states as follows:

> "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 asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or subleasing the asset. The economic benefits from use of an asset *include its primary output and by-products* (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party." [Emphasis added]

In the given case, Entity X has the right to obtain substantially all of the economic benefits from the use of the solar power station over the 20-year period because it obtains:

– electricity produced by the power station i.e. the primary product from use of the asset over the lease term and

– renewable energy credits – i.e. the by-product from use of the asset.

Although Entity Y will receive economic benefits from the solar power station in the form of tax credits, those economic benefits relate to the ownership of the solar power station rather than the use of the power station. Thus, these credits are not considered in this assessment.

Question 15

Entity X (customer) enters into a contract for six years with Entity Y (supplier). As per contract, Entity Y is required to install an air-conditioning plant in its office premises. Air-conditioning plant is designed as per the specifications provided by Entity X. To optimize the efficiency of the air conditioning plant, Entity Y provides operation and maintenance services on regular basis and as and when required throughout the contract period. However, Entity X decides and directs the hours of operation and the floors of the building on which and at what time the cooling is required and the temperature to be maintained by the air conditioning plant.

Whether Entity X has right to direct the use of the air conditioning plant?

Response

Paragraph B24 of Ind AS 116, *inter alia*, states as follows:

> "A customer has the right to direct the use of an identified asset throughout the period of use only if either:
>
> (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
>
> (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
>
> (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
>
> (ii) the 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."

Paragraph B26 of Ind AS 116 provides the examples of decision-making rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used, within the defined scope of the customer's right of use which include:

(a) rights to change when the output is produced (for example, to decide when an item of machinery or a power plant will be used);

(b) rights to change whether the output is produced, and the quantity of that output (for example, to decide whether to produce energy from a power plant and how much energy to produce from that power plant).

Further, paragraph B27 of Ind AS 116 states as follows:

"Examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating or maintaining the asset. Such rights can be held by the customer or the supplier. Although *rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and are often dependent on the decisions about how and for what purpose the asset is used*. However, rights to operate an asset may grant the customer 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 (see paragraph B24(b)(i))."[Emphasis added]

In the given case, Entity X directs how and for what purpose the air conditioning plant is used by specifying:

– the hours of operation and floor on which operation is required (when, whether and how much output is produced); and

– the temperature to be maintained by the air conditioner (how much output is produced)

Although Entity Y has right to operate and maintain the plant and these rights are essential for the efficient use of the plant, as stated in paragraph B27, these are not rights to direct how and for what purpose the asset (air conditioning plant) is used.

Hence, Entity X has the right to direct the use of the air-conditioning plant as it has right to make the decisions about the use of air conditioning plant during the period of contract.

Question 16

Entity X, a utility company (customer) enters into a contract for twenty years with Entity Y, a power company (supplier) to install, operate and maintain a solar power station to fulfill the power requirements of Entity X. The team of professionals engaged by Entity X determined the location of the power station and the specifications of the power station. The power station is to be constructed as per the design and other specifications provided by Entity X.

Entity X has the exclusive right to receive and the obligation to take any energy produced.

Whether Entity X has right to direct the use of the solar power station?

Response

Paragraph B24 of Ind AS 116, *inter alia*, states as follows:

> "A customer has the right to direct the use of an identified asset throughout the period of use only if either:
>
> (a) ……. or
>
> (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
>
> (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
>
> (ii) the 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."

Further paragraph B28 of Ind AS 116 states as follows:

"The relevant decisions about how and for what purpose the asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset."

In given case, the nature of the solar power station is such that all of 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 power station.

As per paragraph B24 (b)(ii) above, in the given case, Entity X has right to direct the use of solar power station. Neither Entity X nor Entity Y decides how and for what purpose the solar power station is used during the period of use because those decisions are predetermined by the design of the asset. As Entity X has designed the solar power station and thereby predetermined any decisions about how and for what purpose it is used, Entity X 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 Entity Y the right to direct how and for what purpose the solar power station is used.

Question 17

Entity X (customer) enters into a contract with a transport agency Entity Y (supplier) to use a particular truck specified in the contract for a period of five years. Entity Y can substitute another truck only in case of breakdown of the truck. As per the terms of contracts, during the five-year contract period, the driver hired by Entity X can operate the truck and Entity X decides how to use the truck (such as when it is used and which goods will be carried and on which route it will operate). However, there are certain contractual limitations to protect the interest of Entity Y in the truck, i.e., restrictions on moving it overseas or making modifications.

Whether Entity X has right to direct the use of the truck?

Response

Paragraph B24 of Ind AS 116 provides that a customer has the right to direct the use of an identified asset throughout the period of use if the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

Paragraph B30 of Ind AS 116 states as follows:

> "A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. 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."

In the given case, Entity X has the right to direct the use of the truck throughout the period of use as it has the right to direct how and for what purpose the truck is used, i.e., whether or when it is used and what it is used for throughout the period of use. The contractual limitations are meant to protect the interest of Entity Y in the truck and hence are protective rights and do not affect the assessment of whether Entity X has the right to direct the use of the asset.

Question 18

Entity X takes on lease a crossover which is explicitly specified in the contract, for a period of two years. As per the contract, Entity X can drive it only up to a maximum of 1,50,000 kilometers during the period of two years.

Considering the cap on the number of kilometers that the crossover can be driven by it, whether Entity X obtains substantially all of the economic benefits from use of the crossover?

Response

Paragraphs B21 and B22 of Ind AS 116 *inter-alia* states as follows:

> "B21 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 asset throughout the period of use (for example, by having exclusive use of the asset throughout that period)…… ."
>
> "B22 When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset (see paragraph B30). For example:
>
> (a) …………
>
> (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 shall consider only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond."

As per the above, to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits. A right that solely protects the supplier's interest in the underlying asset (e.g., limits on the number of miles a customer can drive a supplier's vehicle) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, such a right of the supplier is not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

In the given case, the economic benefits for the permitted mileage will be considered when assessing whether Entity X has the right to obtain substantially all of the economic benefits from use of the vehicle during the contract period and the limit on the number of kilometers the crossover can be driven during the tenure of the contract does not prevent the contract from being a lease.

Question 19

Entity X (customer) enters into an arrangement for a period of five years with Entity Y (supplier) for the right to store its gas in a specified storage tank that has no separate compartments. At inception of the contract, Entity X has storage rights that permit it to use 60% of the capacity of the storage tank throughout the term of the contract. Entity Z, subsidiary of Entity X, has arrangement with Entity Y to use balance 40% capacity of that same storage tank throughout the term of the contract.

Whether there is an identified asset and whether the arrangement would be a lease:

- in the respective stand-alone financial statements of Entity X and Entity Z.
- in the consolidated financial statements of Entity X.

Will the answer be different if Entity Z is an associate or joint venture of Entity X, and not a subsidiary of Entity X?

Response

Paragraph B20 of Ind AS 116 states as follows:

> "A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, 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."

As per the above, if the capacity portion of an identified asset is not physically distinct but represents substantially all of the capacity of the asset, it is an identified asset.

From the perspective of stand-alone financial statements of Entity X and Entity Z, there is not an identified asset, since capacity portion is not physically distinct and neither Entity X nor Entity Z, on stand-alone basis, has the right to use substantially all of the capacity of the asset.

However, from the perspective of the consolidated financial statements, the reporting entity is the group comprising Entity X and Entity Y. As the reporting entity (the group) has the right to use substantially all of the capacity of the asset and hence there is an identified asset and the arrangement would be considered as a lease of the specified storage tank.

If Entity Z is not a subsidiary of Entity X, but its associate or a joint venture, then the accounting will be along the lines of accounting in the stand-alone financial statements of Entity X, since an associate or a joint venture is not included in the definition of 'group' – a group comprises a parent and its subsidiaries only. The reporting entity here is Entity X which does not have right to use substantially all of the capacity of the asset.

Question 20

Entity X enters into a contract with Entity Y for a period of five years for the use of a particular aircraft which is explicitly specified in the contract. The contract details the interior and exterior specifications for the aircraft. It also contains contractual and legal restrictions on where the aircraft can fly. Subject to these restrictions, Entity X decides whether, where and when and for what purpose (i.e., to carry passengers or cargo) the aircraft will fly. Entity Y operates and maintains the aircraft using its own crew.

Whether Entity X has right to control the use the aircraft?

Response

Paragraph B21 of Ind AS 116, *inter alia*, states that, "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 asset throughout the period of use."

Further, paragraph B24 (a) of Ind AS 116, *inter alia*, states that, "a customer has the right to direct how and for what purpose the asset is used throughout the period of use".

Paragraph B25 of Ind AS 116 states as follows:

> "A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract."

Paragraph B27 of Ind AS 116, *inter-alia,* states that, "examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating or maintaining the asset. Such rights can be held by the customer or the supplier. Although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and are often dependent on the decisions about how and for what purpose the asset is used."

Paragraph B30 of Ind AS 116 states that, "a contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. 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."

As per the above, a contractual arrangement may include certain clauses to protect the interests of supplier, i.e., of protective rights and to ensure certain legal and regulatory compliances. Such restrictions on standalone basis do not prevent the customer from having the right to direct the use of the asset.

In the given case, Entity X has the right to obtain substantially all of the economic benefits from use of the aircraft throughout the period of use and accordingly has the right to direct the use of aircraft. The contractual restrictions about where the aircraft can fly define the scope of Entity X's right to use the aircraft. They are protective rights that protect Entity Y's interests, e.g. its investment in the aircraft or to ensure that Entity Y is in compliance of applicable laws and regulations.

Entity Y operates the aircraft but Entity Y's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Instead, these decisions are dependent upon Entity X's decisions about how and for what purpose the aircraft is used.

Entity X makes all relevant decisions regarding whether, where and when the aircraft travels, as well as the passengers and cargo that it will transport through the period of use. Further, Entity X has the right to change these decisions throughout the period of use. Accordingly, Entity X has the right to control the use of the asset during the lease term.

Question 21

In the following scenarios, what are the separate lease components in the contract?

Scenario 1: Entity X leases a gas-fired turbine plant for five years from Entity Y that can be used to produce electricity for its customers. The plant consists of the turbine housed within a building together with the land on which the building is constructed. The economic life of turbine is 15 years. The building was designed specifically to house the turbine and has a similar economic life as the turbine and has no alternative use.

Scenario 2: The above contract in scenario 1 also conveys the right to use an additional plot of land that is adjacent to the building in which the turbine is stored. This plot of land could be developed by the lessee for other uses (e.g., car park).

Response

Paragraph B32 of Ind AS 116 states as follows:

"The right to use an underlying asset is a separate lease component if both:

(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets."

According to the above, the above in case of multiple lease components (such as land and building), the lease components are separated if both the criteria are met:

(i) the customer (lessee) can obtain benefits from the different components on standalone basis or along with certain other resources; and

(ii) the lease components are not highly dependent on or related to each other.

Scenario 1:

In the given scenario, the agreement covers lease of plant, lease of building that houses the plant, and lease of land underlying the building. These lease do not meet the second criterion to be regarded as separate lease components, namely, that the right to use the underlying asset is neither dependent on nor highly interrelated with the other rights of use in the contract. The rights to use the plant, the building, and the land are highly interrelated because each is an input to the combined item for which Entity X (lessee) has contracted (that is, the right to use a gas-fired turbine plant that can produce electricity for distribution to Entity X's customers). Therefore, the contract is regarded as containing only one lease component for accounting purposes.

Scenario 2:

In the given scenario, as Entity X can use the adjacent land for different purposes, (e.g., for a car park), it can be concluded that:

- Entity X can derive benefit from each of (i) the turbine plant (including building and underlying land) and (ii) the adjacent plot of land on its own or together with other readily available resources; and

- the use of adjoining land is not highly dependent on or highly related to the turbine plant and vice versa.

Accordingly, from the perspective of Entity X, the contract contains two lease components: a lease of the turbine plant and a lease of the adjacent plot of land.

Question 22

Entity X is an automobile company and is in the process of manufacturing a new luxury car. It enters into a contractual arrangement with Entity Y, an automotive component manufacturer, for a period of four years to purchase a specialised engine to be used in the new model.

Entity Y is one of the leading automotive components manufacturers which manufacture components for various automobile companies. Entity Y possesses specialised and patented knowledge and highly specialised machinery to manufacture the engine which will be required by Entity X. The contract specifically provides that Entity Y would use its existing manufacturing plant at location L to manufacture the engine for Entity X, as it is not economically and practically feasible to carry out the manufacturing of the engines at any of the other plants owned by Entity Y.

The price charged by Entity Y will be variable depending on the number of units produced and the pricing formula is cost (including fixed cost) plus agreed margin. Entity Y expects to use the plant at location L only to manufacture the engines for Entity X; there is no more than a remote possibility that during the term of the arrangement it will be used to manufacture more than an insignificant amount of the output for other customers.

The plant at location L is operated and maintained by Entity Y and rights of Entity X are confined to determining the quantity of engines to be manufactured for it.

Whether the said arrangement contains a lease under Ind AS 116? How would the arrangement have been classified under Ind AS 17?

Response

Appendix C of Ind AS 17, *Leases* deals with determining whether an arrangement contains a lease. As per the Appendix, the right to control the use of an underlying asset is conveyed if any one of the following conditions is met:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

As per Ind AS 116, 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.

As per paragraph B24 of Ind AS 116, a customer has the right to direct the use of an identified asset throughout the period of use only if either:

(a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or

(b) the relevant decisions about how and for what purpose the asset is used are predetermined and:

    (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or

(ii) the 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.

It would be noted from the above that the criteria for determining whether an arrangement conveys the right to control the use of an asset is conveyed to the purchaser are not exactly identical under the two standards (i.e., Ind AS 17 and Ind AS 116). Consequently, It is not necessary that an arrangement which was identified as being (or containing) a lease under Ind AS 17 will necessarily be identified as being (or containing) a lease under Ind AS 116.

The contractual arrangement in the given scenario would have contained a lease under Ind AS 17 as it contains all the elements required to be an arrangement to be classified as a lease as per that Standard:

(i) There is a contractual arrangement between Entity X and Entity Y.

(ii) As the plant and machinery is mentioned in the contract, so there is an explicitly identified asset in the contract and it is not economically and practically feasible to use an alternative plant and machinery.

(iii) Entity X has the right to control the use of the underlying asset as machinery will be used only to manufacture the engine for Entity X. There is remote possibility that in near future it will be used to manufacture more than an insignificant amount of the output for other customers. Further, the price charged by Entity Y will be variable depending on the number of units produced and is cost (including fixed cost) plus agreed margin, i.e., the price is neither fixed per unit nor a market price.

As per Ind AS 116, there is an identified asset which is specified in the contract and there are no substantive substitution rights but the arrangement does not contains the lease as Entity X does not control the asset because it does not meet **both the conditions** required, i.e., right to use the asset and right to obtain substantially all of the economic benefits from use of the identified asset.

(i) Entity X obtains substantially all of the economic benefits as there is remote possibility that in near future it will be used to manufacture more than an insignificant amount of the output of for other customers.

(ii) Entity X has no right to use the asset as Entity Y decides when and how to operate plant and machinery and Entity X's rights are only related to the quantity of components to be manufactured for its use.

Accordingly, the arrangement does not contains a lease under Ind AS 116.

Question 23

Entity X provides a Customer Y with refrigerators to store the purchased chemicals at the premises of Customer Y. However, the refrigerators are not mentioned or promised to Customer Y in the contract. They are separately provided to prevent deterioration in the quality of the delivered chemicals and to possibly encourage Customer Y to buy more quantity from Company X. The refrigerators provided to customer remain the property of Company X. Each refrigerator bears the logo of Company X and a serial number and other identification marks. Refrigerators are provided by Company X only to certain customers based on Company X's discretion. Company X can substitute refrigerators at its discretion since it retains ownership and there is no agreement preventing it from doing so. However, in practice, substitutions are likely to occur only for maintenance. Substitution would require additional costs to be incurred by Company X in terms of delivery of a replacement refrigerator and collection and return of the refrigerator originally provided to customer.

Customers who have been provided refrigerators are charged the same prices as the other customers, i.e., the prices do not include a hidden charge for provision of refrigerators.

While the refrigerators are in possession of Customer Y, it has full control and access to the refrigerators. Customer Y determines when inventory from the refrigerators is to be withdrawn based on the production demands. Chemicals purchased through subsequent purchase orders will also be placed in the refrigerators.

Whether this arrangement will meet the definition of lease under Ind AS 116?

Response

Paragraph 9 of Ind AS 116 states as follows:

"At inception of a contract, an entity shall assess whether the 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*."[Emphasis added]

The contract does not require refrigerators to be provided to Customer Y.

Company X also does not price the use of the refrigerators by the customer into product prices. The contract between the two entities is for the sale of the chemicals and does not include the provision of refrigerators to store the chemicals. As a result of the above, there are no enforceable rights and obligations created and no identifiable consideration paid in exchange for the use of the refrigerators.

As per the facts of the given case, no enforceable rights and obligations are created and there is no identifiable consideration for the use of the refrigerators by the customer. Accordingly, the arrangement does not meet the definition of a lease per Ind AS 116.

Question 24

Entity X sells an office building to Entity Y for consideration of INR 10,00,000. Immediately before the transaction, carrying amount of the building is INR 5,00,000. At the same time, Entity X enters into a contract with Entity Y, effective immediately, for the right to use the building for 15 years with annual payments of INR 80,000 payable at the end of each year. The transfer of the office building qualifies as a sale (i.e., it satisfies the requirements for determining when a performance obligation is satisfied) under Ind AS 115, *Revenue from Contracts with Customers.* The fair value of the office building on the date of sale is INR 9,00,000.

The incremental borrowing rate of Entity X at the time of the above sale and leaseback transaction is at 10% per annum.

What will the accounting for the above transaction in the books of Entity X and Entity Y?

Response

Paragraph 101 of Ind AS 116, *inter alia*, states as follows:

"If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

(a) …..; and

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

In accordance with the above, as the consideration for the sale of the office building is not at fair value, both Entity X and Entity Y are required to make adjustments to recognise the transaction at fair value. The amount of excess of sale price over fair value is INR 100,000 (1,000,000 - 900,000) which is recognised as additional financing provided by Entity Y to Entity X.

The present value of the annual payments is INR 6,08,486, of which INR 100,000 represents repayment of the additional financing of INR 100,000 and the balance of INR 508,486 represents payment towards lease. Thus, each annual payment can be viewed as comprising of INR 13,147 towards repayment of additional financing and INR 66,853, towards lease rentals (i.e., the annual payment of INR 80,000 is split between the two parts in the ratio of 100,000:508,486) each of which is discounted at 10.% per annum.

Entity Y (buyer-lessor) classifies the lease of the building as an operating lease, applying the requirements of Ind AS 116.

Paragraph 100 of Ind AS 116 states as follows:

"If the transfer of an asset by the seller-lessee satisfies the requirements of Ind AS 115 to be accounted for as a sale of the asset:

(a) the seller-lessee shall measure the right-of-use 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. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

(b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard."

At the commencement date, Entity X (seller-lessee) recognises the transaction as follows:

- It measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount of the building that relates to the right of use retained by it, i.e., [INR 5,00,000 x (INR 5,08,486 / INR 9,00,000) = INR 2,82,492.

  where-

  INR 5,00,000 is the carrying amount of the building at the time of sale and leaseback;

  INR 5,08,486 is the present value of payments to be made towards lease rentals over the 15-year lease term and INR 9,00,000 is the fair value of the building at the time of sale and leaseback.

- The total gain on the sale of the building amounts to INR 400,000 (900,000 - 500,000), of which:
  - INR 2,25,994 [4,00,000 x (5,08,486 / 9,00,000) relates to the right of use of the office building retained by Entity X;
  - INR 1,74,006 [4,00,000 ((9,00,000 – 5,08,486) / 9,00,000) relates to the rights transferred to Entity Y.
- Entity X recognises only the portion of the gain on sale that relates to the rights transferred to Entity Y, i.e., INR 1,74,006.

At the commencement date, Entity X accounts for the transaction as follows:

Bank	10,00,000	
Right-of-use asset	2,82,492	
Building		5,00,000
Financial liability		6,08,486
Gain on rights transferred		1,74,006

At the commencement date, Entity Y accounts for the transaction as follows.

Building	9,00,000	
Financial asset	1,00,000	
(15 payments of INR 13,147, discounted at 10 percent per annum)		
Bank		10,00,000

Entity Y accounts for the lease by treating INR 66,853 out of the annual payments of INR 80,000 as lease payments. The remaining INR 13,147 of annual payments received from Entity X is accounted for as (a) part repayment towards financial asset of INR 1,00,000 and (b) interest revenue.

Question 25

Evaluation of applicability of the sale and leaseback accounting requirements guidance in the following scenarios:

Scenario 1: Seller-lessee repurchase option at discounted price.

Scenario 2: Seller-lessee repurchase option at fair value.

Response

Scenario 1: Seller-lessee repurchase option at discounted price

Ind AS 116 does not address whether a lessee's renewal options (e.g., fixed price, fair value at the date of exercise) permitting the seller-lessee to extend the lease for substantially all of the remaining economic life of the underlying asset precludes sale accounting. It seems a lessee that has an option to extend a lease for substantially all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Therefore, when the renewal price is not fair value at the time the renewal option is exercised, the renewal option would prohibit sale accounting under Ind AS 115 and Ind AS 116. Thus, sale and leaseback guidance is not applicable and the transaction is accounted as a normal financing transaction for the seller lessee.

Scenario 2: Seller-lessee repurchase option at fair value

If a repurchase option is granted to the seller-lessee at fair value (and in circumstances where substantially the same assets as the underlying asset are available in the marketplace) it cannot be concluded that such an option is non-substantive even though the option has a fair value of zero. This does not mean that it has no substance since the existence of the option limits the buyer-lessor in its ability to direct the use of the underlying asset (e.g. by preventing the buyer-lessor from selling the underlying asset in the course of the leaseback contract). In this scenario also, sale and leaseback guidance is not applicable and the transaction is accounted as a normal financing transaction for the seller lessee.

Question 26

What is the lease term for assessing right of use asset and lease liability in the following scenarios?

Scenario A

Entity X (lessee) enters into a contract with Entity Y to lease a machinery for a non-cancellable period of three years. The contract includes a three-year fixed-priced renewal option. The future lease payments that are expected to approximate market rates at the time of lease renewal.

Following is additional relevant information:

- The machinery is to be used in manufacturing components for a type of mobile handset that Entity X expects will remain popular with customers until development and testing of an improved model are completed in approximately 3 years.
- The cost to install the machinery in Entity X's facility is not significant.
- Entity X does not expect to use the machinery in manufacturing any other type of handset.
- The remaining economic life of the machinery is 12 years.

Scenario B

Entity X (lessee) enters into a lease contract for a retail shop in a market place for an initial non-cancellable period of four years. The contract includes a renewal option for a period of further three years at the same lease rentals. Before it takes possession of the building, Entity X pays for leasehold improvements carried at its behest by the lessor.

Following is additional relevant information:

- At inception of the lease, the rentals are based on the market rates. However, the market rentals for a comparable shop in the same market area are expected to increase by 12 percent per annum over the 7 year period covered by the lease.
- Entity X anticipates that it will run the shop in the same area for at least 8 to 10 years.
- The location of the shop is advantageous for a profitable business.
- The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realised through continued occupancy of the leased property.

Response

Paragraph 18 of Ind AS 116 states as follows:

"An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."

Further, paragraph B37 of Ind AS 116 *inter-alia* states as follows:

"At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers 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. Examples of factors to consider include, but are not limited to:

(a) contractual terms and conditions for the optional periods compared with market rates, such as:

   (i) the amount of payments for the lease in any optional period;

   (ii) the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and

   (iii) the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

(b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;

(c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;

(d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives; and

(e) …"

Further, paragraph B39 of Ind AS 116 states as follows:

"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."

The Standard does not contain guidance on how much weightage is to be given to each of the individual factors when determining whether it is 'reasonably certain' that a lessee will exercise a renewal option (or not exercise a termination option). Accordingly, judgement is required to be exercised to determine the weightage to be given to different factors indicated above.

Scenario A

In the given scenario, Entity X does not expect to use the machinery in manufacturing any other type of handset. Also, the lease payments on renewals are expected to approximate market rate at the time of renewal. Further, there are no significant costs to install the machinery and also as there are no termination penalties to be incurred if Entity X decides not to renew the lease after the initial three year period. Based on above, it can be concluded that there is no economic incentive for Entity X to exercise the renewal option. Entity X, therefore, concludes that the lease term is three years.

Scenario B

In the given scenario, at lease commencement date, Entity X determines that it is reasonably certain to exercise the renewal option because it would benefit from the lower rentals that it will pay as compared to the market rates and also it will suffer a significant economic penalty if it abandons the leasehold improvements at the end of the initial non-cancellable period. Therefore, at lease commencement, Entity X concludes that the lease term is seven years (i.e., initial non-cancellable period of four years and a three-year renewal period).

Termination option

Question 27

Entity X (lessee) enters into a lease for a major new store location with Entity Y (lessor) for an unspecified period of time. As per the terms of contract, the lease can be terminated at any time by Entity X by giving eight months' notice prior to terminating the lease and pay a penalty equal in amount to two months' rent. The lease rentals will be reset every year to market rates.

Entity X is not expected to benefit economically from shifting the store to a new location, as it has undertaken significant immovable leasehold improvements and which can be effectively utilised, only if it continues the lease for at least five years. Entity X has internally budgeted the revenue from this outlet for next five years.

What is the lease term from the perspective of Entity X?

Response

Paragraph 18 of Ind AS 116 states as follows:

> "An entity shall determine the lease term as the non-cancellable period of a lease, together with both:
>
> (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
>
> (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."

Further, paragraph B34 of Ind AS 116 states as follows:

> "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 lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty".

In applying paragraph B34 and determining the enforceable period of the lease, an entity should consider the broader economics of the contract and not only contractual termination payments. If either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant, the contract is enforceable beyond the date on which the contract can be terminated.

In the given case, Entity X has incurred significant expenditure on the leasehold improvements created in the store which cannot be removed and used elsewhere if the lease is terminated. Thus, Entity X effectively has an economic compulsion to not terminate the lease before five years without incurring a significant penalty in terms of the loss of the investment in the leasehold improvements. Further, Entity X has also budgeted revenue from the new store location for five years.

From the above, it can be concluded that although the contract can be terminated by either party by giving notice as per the terms stated in contract, but since Entity X will incur more than an insignificant penalty, if it terminates the contract, it can be construed that it should consider the contract as enforceable for at least the period of expected utility of leasehold improvements, i.e. for a period of five years in the given case. Accordingly, in the given case, the lease term to be considered by Entity X will be of five years.

Cancellable leases

Question 28

In the following scenarios what will be the lease term?

Scenario I:

A lease has a contract period of five years but can be terminated any time after the end of the third year at the option of the lessor or the lessee without incurring any significant penalty.

Scenario II:

A lease has an initial contract period of five years but can be terminated by the lessor at any time after the end of the third year without requiring the lessee's consent.

Response

Scenario I:

Paragraph B34 of Ind AS 116, states as follows:

> "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 lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty".

In the given case, although the total contract period is for five years, the non-cancellable period is three years. As both the lessor and the lessee, both have the substantive right to cancel the lease without any significant penalty, the contract will no longer be enforceable after three years.

In view of the above, in the given case, the lease term is of three years.

Scenario II:

Paragraph B35 of Ind AS 116 states as follows:

> "If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease".

The logic for the above is that if, the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.

In the given scenario as the initial contract period of five-year period meets the definition of a contract because it creates enforceable rights and obligations that can only be terminated by the lessor, the lease term is of five years.

Lease term determination in case of sublease

Question 29

Entity X enters into a contract with Entity Y to take on lease a parcel of land (the head lease) for an initial five-year term followed by four successive five-year renewal options without requiring the consent of the lessor. At lease inception, Entity X considers the lease term to be five years since it is not reasonably certain to exercise the renewal options.

A few months after the commencement of the head lease, Entity X enters into a lease (as an intermediate lessor) with Radio Station Z (sub lessee) for an initial term of eight years followed by three successive four-year renewals at Radio Station Z's option. Radio Station Z (sub lessee) constructs a radio tower on the land.

Entity X does not currently have any viable plans for any alternative use of the land in case Radio Station Z does not exercise the renewal option at the end of the sublease period of eight years.

Given the recent history of closure of several radio stations due to commercial non-viability, Entity X is not reasonably certain at lease inception that Radio Station Z would exercise the renewal options.

Does the lease term as determined by Entity X initially require re-assessment when it enters into sub-lease with Radio Station Z and if yes, what would be the re-assessed lease term?

Response

Paragraphs 18 and 20 of Ind AS 116 state as follows:

> "18 An entity shall determine the lease term as the non-cancellable period of a lease, together with both:
>
> (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
>
> (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."
>
> "20 A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:
>
> (a) is within the control of the lessee; and
>
> (b) affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its

determination of the lease term (as described in paragraph B41)."

Further, paragraph B37 of Ind AS 116 states as follows:

> "At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers 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. Examples of factors to consider include, but are not limited to:
>
> (a)……
>
> (d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives……. "

Paragraph B41 of Ind AS 116 states as follows:

> "…..after the commencement date, a lessee reassesses the lease term upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term. Examples of significant events or changes in circumstances include:
>
> (a) ……
>
> (c) the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and…."

In the given case, after commencement of the head lease, Entity X has sub-leased the land for an initial period of eight years which is more than the non-cancellable period of head lease five years from the date of commencement of the head lease. It is clear that to meet its contractual obligation under the sublease, Entity X would be required to exercise its first five-year renewal option, i.e., the one exercisable at the end of the non-cancellable period of five years. However, since Entity X is not reasonably certain that the sub lessee will exercise its renewal options and Entity X does not have any viable plans for any alternative use of the land in case the sub lessee does not exercise the renewal option at the end of the eight-year period. Entity X cannot be reasonably certain of exercising the renewal option at the end of ten years of the head lease. Accordingly, the lease term used by Entity X in its accounting for the head lease needs to be reassessed on the date of sublease to be 10 years. (i.e., five years of non-cancellable period and five years of renewal period) from the date of commencement of the head lease.

Residual value guarantee

Question 30

Entity X (lessee) enters into a contract with Entity Y to lease a machinery for a term of five years, with Entity Y having an option to terminate the lease at the end of three years. Under the agreement, Entity X guarantees to Entity Y that if Entity X terminates the lease at the end of three years and the residual value of the underlying asset at the end of three years is less than INR 2 lakhs, it will compensate Entity Y for the shortfall.

What will be the lease term?

Response:

Paragraphs 18 of Ind AS 116 states as follows:

> "18 An entity shall determine the lease term as the non-cancellable period of a lease, together with both:
>
> (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
>
> (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."

Further, paragraph B37 of Ind AS 116 states as follows:

> "At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers 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. Examples of factors to consider include, but are not limited to:

(a) contractual terms and conditions for the optional periods compared with market rates, such as:

(i) …

(ii) the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees;….”

In the given case, Entity X and Entity Y would evaluate the residual value guarantee of INR 2 Lakhs, in light of other factors, to determine whether it serves as a penalty comparable to market rate such that the lessee is reasonably certain to not exercise its termination option due to the existence of the guarantee.

Accordingly, if Entity X is reasonably certain to not exercise its termination option, the lease term would be five years.

Perpetual Lease

Question 31

Airline X (lessee) has entered into a lease arrangement with Entity Y (lessor) to take an aircraft on lease for which it pays monthly rental to Entity Y. There are no termination clauses for the contract, except in case of default in rental payment by the lessee.

What is the lease term?

Response

Ind AS 116 defines lease term as follows:

“The non-cancellable period for which a lessee has the right to use an underlying asset together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."

In the given case, since there is no defined period of time and no termination clause, the non-cancellable period for the lease can be said to be till perpetuity since lessee has the enforceable contractual right to use the underlying asset till perpetuity for exchange of consideration.

In this case, the lease term should be taken as the remaining economic life of the underlying asset, i.e., the aircraft, except if there are any legal or other economic factors due to which Entity X would not be able to use the aircraft for its entire remaining economic life.

Contracts with term of 12 months or less

Question 32

Several years back, Entity X (lessee) entered into a lease agreement to take on lease an office building from Entity Y (lessor) for a period of eleven months with no renewal terms. Since then, the contract has been renewed (by entering into a fresh lease agreement) by mutual consent of the parties for a further period of eleven months at a time at the expiry of its current term On expiry of previous lease agreement, a fresh lease agreement is entered into on April 15, 2019. Based on the historical experience, it is considered likely that the contract will be renewed for another eleven months at the expiry of its current term.

The lease agreement does not provide any purchase option in respect of the leased asset to the lessee.

What is the lease term?

Response

Paragraph 5 of Ind AS 116, *Leases*, states the following, *inter alia*:

"A lessee may elect not to apply the requirements in paragraphs 22-49 to:

(a) short-term leases; and

(b) ...."

Ind AS 116 defines the terms 'lease' and 'short-term lease' as follows:

Lease term

"The non-cancellable period for which a lessee has the right to use an underlying asset together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."

Short-term lease

"A lease that, at the commencement date, has a lease term of 12 months or less is a short term lease. A lease that contains a purchase option is not a short-term lease".

Paragraph B34 of Ind AS 116 states the following, *inter alia*:

"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."

The term 'contract' is defined in the standard as follows:

"An agreement between two or more parties that creates enforceable rights and obligations."

As per a combined reading of the above, in determining the lease term (and therefore, in determining whether a lease is a short-term lease), only the enforceable rights of the lessee to renew or extend the lease beyond the non-cancellable period are taken into consideration. For example:

- Where a lease agreement grants the lessee a right (an option) to renew or extend the lessee beyond the non-cancellable period without the consent of the lessor, the lessee has the right to use the asset beyond the non-cancellable period. Accordingly, the period covered by the lessee's option to renew or extend the lease is included in the lease term if the lessee is reasonably certain to exercise that option.
- In contrast, where a lease agreement can be renewed or extended by the lessee beyond the non-cancellable period only with the consent of the lessor, the lessee does not have the right to use the asset beyond the non-cancellable period. By definition, there is no contract beyond the non-cancellable period if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term.

In view of the above, where a lease agreement (including any addendum thereto or a side agreement) is entered into for a period of 12 months or less and does not grant a renewal or extension option to the lessee, it qualifies as a short-term lease within the meaning of the standard (provided it also does not grant a purchase option to the lessee). This is so even if there is a past practice of the lease being renewed upon expiry for a further period of 12 months or less at a time with the mutual consent of the lessee and the lessor.

In the given case, the non-cancellable period of the lease is eleven months and there is no option to extend the lease. Although, in the past, Entity X and Entity Y have entered into a fresh contract at the end of every 11^{th} month, Entity X does not have right to control the asset beyond the lease term of eleven months. Therefore, the lease term for the above contract is eleven months and Entity X is entitled to avail the exemption for short-term lease contract.

Reassessment of lease term

Question 33

In the following scenarios when will the least term be reassessed?

Scenario I: Re-assessment of exercise of lease extension option

Entity X (lessee) enters into a lease for a building floor for its corporate office for an initial period of five years, followed by three successive five-year renewal options. At the commencement date, Entity X is not reasonably certain to exercise the renewal option. During the third year, Entity X acquired a business. Entity X assessed that the employees of the new business acquired and the existing employees need to be present at the same location and cannot efficiently operate from different locations. Accordingly, at the end of third year, Entity X decided to lease another floor from the beginning of year 4 in the same building and entered into a separate seven-year lease for the additional floor in the building.

Scenario B: Re-assessment of non-cancellable period of lease

Entity X (lessee) takes ten vehicles on lease for an initial period of 5 years along with an option to extend the lease for a further period of 5 years at the same rental amount. The remaining useful life of each of the vehicles as at the commencement date of the lease is 12 years. Entity X determines at the commencement date that it is reasonably certain to exercise the extension option and hence it takes the lease term as ten years.

At the end of year 3, there is an announcement by the government that all the vehicles of this particular model have to be taken off the road within next one year due to the change in the pollution norms in the country.

The agreement states that it shall stand terminated if either of the party is prevented in performing its obligations under the terms of the agreement by reason of any restrictive governmental laws or regulations, riots, insurrection, war, terrorist action, strike, public demonstrations, rallies, acts of God etc.?

Response

Scenario I

Paragraph B41 of Ind AS 116 states as follows:

> "Paragraph 20 specifies that, after the commencement date, a lessee reassesses the lease term upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term. Examples of significant events or changes in circumstances include:
>
> (a) significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
>
> (b) a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
>
> (c) the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
>
> (d) a business decision of the lessee that is directly relevant to exercising, or not exercising, an option (for example, a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is employed)."

Paragraph B41 (d) requires a lessee to reassess the lease term if there is a business decision of the lessee that is directly relevant to exercising or not exercising an option to renew / extend the lease.

In the given case, at the end of third year, Entity X has leased another floor in the same building on account of acquiring a business by entering to a fresh lease for a seven-year term indicating Entity X's intention to continue operating its corporate office from the current building for at least another seven years.

Therefore, at the end of the third year, it is reasonably certain that Entity X will exercise the renewal option of the original lease for a further five-year term. Hence, Entity X will have to reassess the lease term of the original lease at the end of third year.

Scenario II:

Paragraph 21 of Ind AS 116 states as follows:

> "An entity shall revise the lease term if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:
>
> (a) the lessee exercises an option not previously included in the entity's determination of the lease term;
>
> (b) the lessee does not exercise an option previously included in the entity's determination of the lease term;
>
> (c) an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or
>
> (d) an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term."

In the given case, the agreement clearly states that it shall stand terminated if either of the party is prevented in performing its obligations under the terms of the agreement by reason of any restrictive governmental laws or regulations, riots, insurrection, war, terrorist action, strike, public demonstrations, rallies, acts of God etc.

Therefore, as stated above in paragraph, at the end of third year, Entity X will reassess the remaining lease term since an event has occurred which contractually prohibits Entity X from exercising the option that was included in the lease term.

Accounting by Lessee

Lease Recognition:

Inception date vs Commencement date

Question 34

Entity X (lessee) entered into a franchise agreement with Entity Y (franchisor-lessor) for opening a new store in the premises owned by Entity Y. The agreement is dated April 1, 2019. As per the contract, Entity X is required to make lease payments beginning from July 1, 2019 when the store is expected to open. Before the store opening, Entity X has to make some leasehold improvements to structure the store as per its requirements for which Entity Y provides the premises from May 1, 2019.

Entity X has concluded that the arrangement contains a lease for the premises.

When will Entity X recognise the right-of-use asset and the lease liability relating to the lease?

Response

Ind AS 116 defines the terms 'commencement date' and 'inception date' as follows:

Commencement date

"The date on which a lessor makes an underlying asset available for use by a lessee."

Inception date

"The inception date of the lease is the earlier of date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease."

Paragraph 9 of Ind AS 116, *inter alia*, states as follows:

> "At inception of a contract, an entity shall assess whether the 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."

Further, paragraph 22 of Ind AS 116 states as follows:

> "At the *commencement date*, a lessee shall recognise a right-of-use asset and a lease liability".

In the given case, inception date is the date of the agreement, i.e., April 1, 2019. At this date Entity X has to determine whether or not the arrangement is, or contains, a lease.

In the given case, to make certain leasehold improvements, the lessee has taken the possession of the underlying asset before it begins operations or making lease payments under the terms of the lease.

As per the definition stated above, commencement date is the date on which a lessor makes an underlying asset available for use by a lessee. The timing when the lease payments start does not affect the determination of commencement date of the lease.

Accordingly, in the given case, since Entity Y has made the premises available to Entity X on May 1, 2019 for carrying out leasehold improvements, the lease commencement date is May 1, 2019 and accordingly, Entity X is required to recognise the right of use asset and lease liability as on that date.

Low-value assets

Question 35

As per paragraph 5 of Ind AS 115, a lessee may elect not to apply the requirements in paragraphs 22-49 (which describes the lessee's accounting model) to leases for which the underlying asset is of low value. Under Ind AS 116, what can be considered as a low value asset?

Response

Paragraphs B4-B8 of Ind AS 116 state as follows:

> "B4 The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the accounting treatment in paragraph 6 regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value."
>
> "B5 An underlying asset can be of low value only if:

(a) 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; and

(b) the underlying asset is not highly dependent on, or highly interrelated with, other assets."

"B6 A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value."

"B7 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."

"B8 Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones."

Based on the above guidance, the following points need to be borne in mind in making an assessment as to whether an underlying asset of a lease is of low value:

(i) Such assessment is performed on an absolute basis and is independent of the size, nature or circumstances of the lessee.

(ii) The assessment is based on the value of the asset when new, regardless of the age of the asset that is the subject matter of the lease.

(iii) In case the asset that is the subject matter of the lease is subleased, or is expected to be subleased, the head lease does not qualify as a lease of low-value asset.

It may be mentioned that election of exemption for leases of low-value assets is available on lease-by-lease basis.

Lease of low value assets

Question 36

Entity X is in the business of manufacturing and selling fast-moving consumer goods (FMCG) and has entered into the following lease arrangements as lessee:

(a) Leases of office buildings and warehouses.

(b) Leases of manufacturing plant and machinery.

(c) Leases of vehicles such as cars for employees and senior managements and of varying quality, specifications and value.

(d) Leases of trucks and vans used for delivery purposes, of varying size and value.

(e) Leases of laptop computers, desktop computers and mobile phones for employees.

(f) Leases of high-end servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as Lessee has needed to increase the storage capacity of the servers.

(g) Leases of office equipment:

  (i) office furniture (such as chairs, desks and office partitions);

  (ii) water dispensers; and

  (iii) high-capacity multifunction photocopier devices.

Does each of the above assets qualify to be a low value asset and whether Entity X can elect to apply the low-value asset exemption to all of the assets in the contract?

Response

Paragraphs B5-B8 of Ind AS 116 state as follows:

"B5 An underlying asset can be of low value only if:

(a) 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; and

(b) the underlying asset is not highly dependent on, or highly interrelated with, other assets."

"B6 A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value."

> "B7 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."
>
> "B8 Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones."

Applying the above, in the given case, Entity X determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are individually of low value:

(a) Leases of IT equipment for use by individual employees; and

(b) Leases of office furniture and water dispensers.

Leases of modules do qualify as leases of low-value assets. This is because, although an individual module might be an asset of low value, each module is highly interrelated with other parts of the servers. The entity would not lease the modules without leasing the servers.

Paragraph 6 of Ind AS 116 provides that, if a lessee elects for the exemption from applying the recognition, measurement and presentation requirements as specified in the Standard leases for which the underlying asset is of low value (or for short-term leases), 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. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

Accordingly, Entity X will 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 lease exemption

Question 37

Entity X has entered into lease agreements to lease several items of office equipment. The items of office equipment are all considered to be of the same class as they are of similar nature and use in Entity X's operation. The lease term of some of the items is 12 months or less, with no renewal option.

The lease agreement does not provide any purchase option in respect of the leased asset to Entity X.

For which of the leases can Entity X exercise the short term lease exemption?

Response

Ind AS 116 defines 'short term lease' as follows:

> "A lease that, at the commencement date, has a lease term of 12 months or less is a short term lease. A lease that contains a purchase option is not a short-term lease".

Further, paragraph 8 of Ind AS 116 states as follows:

> "The election for short-term leases shall 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. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis".

As per above paragraphs, if Entity X elects to use short term exemption it must apply that exemption to all leases of the same class of underlying asset, i.e. office equipment leases with terms of 12 months or less. Further, once Entity X adopts a policy of classifying such leases as short-term, all future leases of office equipment with a lease term of 12 months or less will be accounted for short term leases. Any change in that accounting policy will be made only in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.* However, Entity X will have the option to elect whether or not to apply the exemption to leases of any other class of assets such as machinery.

Measurement in case of recognition exemption

Question 38

Entity X (lessee) enters into a lease agreement with Entity Y (lessor) to lease office equipment for a lease term of 5 years. The equipment is determined by Entity X to be of low value. Entity X elects to apply low value asset exemption. Lease payments for five years are as follows:

Year 1 - Nil (rent-free)

Year 2 & 3 - INR 1,000 p.a.

Year 4 & 5 - INR 1,200 p.a.

The escalations in lease rentals for years 4 and 5 are in line with the expected inflation rates in the economy. Entity Y provides a lease incentive of INR 300 to Entity X at lease commencement.

How would the lease payments and lease incentive be recognized by Entity X?

Response

Paragraph 6 of Ind AS 116 states as follows:

> "If a lessee elects not to apply the requirements in paragraphs 22–49 to either short-term leases or leases for which the underlying asset is of low value, 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. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit".

In accordance with the above, if Entity X elects to apply low value asset exemption for the lease of office equipment, it would be required to recognise the lease expense on straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even though the escalations in lease rentals is linked to inflation. Accordingly, the expense to be recognised would as follows (assuming Entity X determines that application of a basis other than straight-line is not appropriate under the circumstances):

- Total lease payments , net of lease incentive provided by lessor =INR: INR 4,100

  (1,000*2) + (1,200*2) – 300)
- Lease term+ 5 years
- Annual lease expense: INR 820

  (INR 4,100/5years)

Initial Measurement: In-substance fixed lease payment

Question 39

Entity X (lessee) enters into a five-year lease for a machinery. The contract sets out the lease payments as follows:

- If Entity X uses the machinery within a given month, then an amount of INR 20,000 accrues for that month.
- If Entity X does not use the machinery within a given month, then an amount of INR 10,000 accrues for that month.
- Payments are to be made at the end of the year.

What amount would be considered to be the lease payments for the purpose of measuring lease liability?

Response

Paragraph 27 of Ind AS 116 states as follows:

> "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:
>
> (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;
>
> (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);
>
> (c) ..."

Further, paragraph B42(c) of Ind AS 116, *inter alia*, states that, "lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, 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 this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments."

Accordingly in the given case, Entity X is required to evaluate whether there is a realistic possibility that it may not use the machinery in some months. If the evaluation is in the affirmative it will be required to a make monthly payment of INR 10,000 is unavoidable.

This unavoidable payment is an in-substance fixed payment, and would be considered in the measurement of the lease liability. Entity X will account for the variable lease payments which might be incurred based on usage, i.e., amounts of INR 15,000 which is over and above the in-substance fixed payment of INR 10,000 in profit or loss as and when incurred.

Fixed or Variable payments

Question 40

In the following scenarios, what payments are to be considered for purposes of calculating lease liability:

Scenario A: No minimum payment requirement:

Entity X (lessee) enters into a 20-year contract with a power company, Entity Y (lessor) to purchase electricity produced by a new solar plant set up by Entity Y. Entity X and Entity Y assess that the contract contains a lease. There are no minimum payment requirements, and no fixed payments that Entity X is required to make to Entity Y. However, Entity X is required to purchase all of the electricity produced by the solar plant at a price of INR 10 per unit. It is highly probable that the solar plant will generate at least some electricity each year

Scenario B: Some minimum payment requirement:

Entity X (lessee) enters into a 20-year contract with a power company, Entity Y (lessor) to purchase electricity produced by a new solar plant set up by Entity Y. Entity X and Entity Y assess that the contract contains a lease. Entity X has to make a payment of a minimum of INR 10,000 to Entity Y. Further, Entity X is required to purchase all of the electricity produced by the solar plant at a price of INR 10 per unit.

Response

Paragraph 27 of Ind AS 116 states as follows:

> "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:
>
> (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;

(b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);

(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 (assessed considering the factors described in paragraphs B37–B40); and

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

Further, paragraph 38 of Ind AS 116 states as follows:

"After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:

(a) interest on the lease liability; and

(b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs."

Paragraph B49 of Ind AS 116 states as follows:

Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for using variable lease payments and the prevalence of those payments;

(b) the relative magnitude of variable lease payments to fixed payments;

(c) key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and

(d) other operational and financial effects of variable lease payments.

Scenario A:

In given case, although it is highly probable that the solar plant will generate at least some electricity each year, the whole payment that Entity X makes to Entity Y varies with the amount of electricity produced by the solar plant – i.e. the payments are fully variable. These variable lease payments are not dependent on an index or a rate. Hence, they are excluded from calculation of lease liability as at the commencement date.

Therefore, in accordance with the above-mentioned paragraphs it can be concluded that there are no fixed or in-substance fixed lease payments (or variable lease payments that depend on an index or a rate) in the contract. Accordingly, Entity X would not recognise any lease liability or right-of-use asset in respect of the lease and would recognise the payments to be made to Entity Y in the statement of profit or loss as and when it purchases electricity from Entity Y. Further, Entity X shall need to consider providing all the disclosures as specified in paragraph B49 of Ind AS 116 with respect to variable lease payments.

Scenario B:

Paragraph B42 of Ind AS 116 *inter alia* states that, "Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable…"

In the given case, Entity X is required to make a minimum payment of INR 10,000 each year which is unavoidable. However, any payments above INR 10,000 that Entity X makes to Entity Y vary with the amount of electricity produced by the solar farm – i.e. such payments are variable. As these variable lease payments are not dependent on any index or a rate, they are excluded from calculation of lease liability and right-of-use asset as at the commencement date.

To conclude, the annual payments of INR 10,000 are in-substance fixed lease payments and will be considered in measuring the lease liability and right-of-use asset at the commencement date whereas any payments over and above the aforementioned amount of INR 10,000 per annum will be recognised in profit or loss as and when they are incurred.

Variable lease payments

Question 41

Entity X (lessee) enters into a lease arrangement for a period of 10 years to lease a retail office space with Entity Y (lessor). The annual lease payments, to be paid in arrears at the end of each year are INR 2 lakhs plus an amount equal to 5% of Entity X's sales for the year. Entity X's annual sales have always exceeded INR 2 crores ever since it began operations and are projected to grow at a rate of 10% annually. What are the lease payments for purposes of calculating lease liability and right-of-use asset?

Response

Para 27 of Ind AS 116 states as follows:

> "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:
>
> (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;
>
> (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);
>
> (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 (assessed considering the factors described in paragraphs B37–B40); and
>
> (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease."

Further, paragraph 38 of Ind AS 116 states as follows:

> "After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:
>
> (a) interest on the lease liability; and

(b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs."

In the given case, the lease payments for purposes of calculation of lease liability and right-of-use asset are only the fixed annual lease payments of INR 2 lakhs. Although in the light of historical results and projections of Entity X, there is a high probability of some variable lease payments being made, the variable lease payments are based exclusively on, and vary with, the performance of the underlying asset. As the variable lease payments are not dependent on an index or a rate, they are excluded from calculation of lease liability and right-of-use asset at the commencement date.

Entity X would recognise the variable payments in profit or loss as and when they are incurred.

Variable payment linked to index

Question 42

Entity X (lessee) enters into a lease agreement with Y (lessor) to rent a property. The lease term is five years. The first year rental is INR 4,50,000. The annual rental will change every year by percentage change in the Consumer Price Index (CPI) index vis-à-vis the previous year. CPI at the beginning of year 2 is higher than the CPI at lease commencement. Payments are made at the end of each year. How does Entity X initially measure the lease liability? Is Entity X required to reassess the lease liability at the beginning of second year?

Response

Paragraph 27 of Ind AS 116 states as follows:

"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:

(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;

(b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);

(c) ...”

In accordance with paragraph 27(b) above, to measure the lease liability at commencement date, Entity X assumes an annual rental of INR 4,50,000.

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A*B=C)
Year 1	4,50,000	0.91	4,09,500
Year 2	4,50,000	0.83	3,73,500
Year 3	4,50,000	0.75	3,37,500
Year 4	4,50,000	0.68	3,06,000
Year 5	4,50,000	0.62	2,79,000
Lease liability at commencement date			**17,05,500**

In Year 2, because there is a change in the future lease payments resulting from a change in the CPI, which is used to determine those lease payments, Entity X needs to remeasure the lease liability.

Question 43

What are the lease payments for purposes of calculating ROU asset in the following scenarios?

Scenario A: Entity X (lessee) enters into an agreement to lease an aircraft for a period of 10 years from Entity Y (lessor). It is agreed that at the end of the lease, Entity X will pay INR 200,000 for restoring of the aircraft irrespective of usage of aircraft.

Scenario B: Entity X (lessee) enters into an agreement to lease an aircraft for a period of 10 years from Entity Y (lessor). As per the terms of the lease contract, apart from lease rentals, Entity X is required to pay INR. 20,000 annually to the lessor towards major overhaul expenditure that the lessor expects to incur for the aircraft. The amount is payable irrespective of the actual usage of the aircraft and irrespective of whether the lessor actually incurs any major overhaul expenditure or not.

Scenario C: Entity X (lessee) enters into an agreement to lease an aircraft for a period of 10 years from Entity Y (lessor). As part of the lease arrangement, it is agreed that the aircraft will undergo major overhaul expense at the end of 4th and 8th years irrespective of the flying hours clocked and that the expenditure for the same will be borne by the Entity X.

Response

Scenario A:

In the given scenario, as the Entity X will incur cost for restoring the aircraft (the underlying asset) at the end of the lease, the same gives rise to an obligation. As a result, Entity X has to recognise a provision for the costs of restoration of the aircraft ("present value of the expected cost") at the beginning of the lease term. Further, in accordance with paragraph 24(d) of Ind AS 116, these costs should be included in the cost of the right-of-use (ROU) asset.

Scenario B:

In the given scenario, the payment of INR 20,000 annually is the payment made to the lessor irrespective of the usage or actual incurring of major overhaul expenditure and hence will be included in the lease payments for computation of lease liability and right of use asset.

Scenario C:

Paragraph 24 of Ind AS 116 states as follows:

> "16 The cost of the right-of-use asset shall comprise:
>
> (a) …
>
> (b) …
>
> (c) …
>
> (d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a

particular period."

In the given scenario, Entity X will undergo major maintenance or overhaul at the end of 4th and 8th years of the lease term. As per paragraph 24(d) of Ind AS 116, the estimate of costs to be incurred for restoring the underlying asset as per the terms of the lease is to be included as a part of cost of ROU asset and depreciated over the lease term i.e., 10 years. However, as per paragraph 31 of Ind AS 116, a lessee shall apply the requirements in Ind AS 16, *Property, Plant and Equipment*, in depreciating the ROU asset. Thus, Entity X may depreciate the major overhaul costs as a separate component over the useful life of 4 years and at the end of the 4th year, capitalise the estimate of the costs to be incurred at the end of the next 4 years' period.

Initial Direct costs

Question 44

Ind AS 116 requires lessees to include initial direct costs in their initial measurement of the right–of-use asset. Which costs can be included as part of initial direct costs?

Response

Ind AS 116 defines 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."

As per the above definition, only 'incremental costs' are included in initial direct costs. Thus, costs that are directly attributable to obtaining a lease but are incurred irrespective of whether the lease is actually obtained or not do not satisfy the definition of initial direct costs.

Examples of costs (only if incremental) that would commonly be included in initial direct costs are:

- Commissions;
- legal fees;
- costs of negotiating lease terms and conditions;
- costs of arranging/providing collateral;
- payments made to existing tenants to obtain the lease.

Allocation of consideration -Property taxes

Question 45

Entity X (lessee) enters into an agreement with Entity Y (lessor) for a period of five years to lease a portion of a building. Entity X is required to make a fixed annual lease payment of INR 3,50,000 (i.e., total payment of INR 17,50,000 over the five-year term). As per the terms of the contract, the INR 3,50,000 annual payment comprises :

	INR
Building rent	2,00,000
Common area maintenance services charge	70,000
Property taxes (pro-rata)	50,000
Building insurance (pro-rata)	30,000

From Entity X's perspective, the estimated stand-alone price of the building rent is INR 2,20,000, and the estimated stand-alone price of the common area maintenance service is INR 80,000 Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component (s) from lease component(s) and accordingly it separates non-lease components from lease components.

Whether the property taxes paid by lessee should be considered as a part of lease payment?

Response

Paragraphs 12 and 15 of Ind AS 116 state as follows:

> "12 For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15."
>
> 15 As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component……."

Paragraph B33 of Ind AS 116 states as follows:

> "A contract may include an amount payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease, that do not transfer a good or service to the lessee. Such amounts payable do not give rise to a separate component of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract."

The payments to be made by Entity X for common area maintenance represents payment for non-lease components as it is a payment for a service provided to it by Entity Y.

The property taxes are required to be paid by Entity Y regardless of whether it leased the building and to which party. Similarly, the building insurance paid by Entity X also protects the Entity Y's property and only Entity Y will be entitled to receive the claim if received. Accordingly, these 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).

As Entity X has not elected the practical expedient as provided in paragraph 15, it will separate the lease and the non-lease components but despite the fact that the agreement specified payments for four separately identified matters, the arrangement will comprise only two components for accounting purposes.

The total annual payment of INR 3,50,000 would be allocated between the two identified goods and services representing the lease component and non-lease component as follows:

Particulars	**Standalone prices**	**% of Total Stand-alone Price**	**Allocation of annual payment***
Building rent	2,20,000	73.3%	2,56,550
Maintenance services	80,000	26.7%	93,450
Total	**3,00,000**	**100%**	**3,50,000**

*The portion of consideration that is allocated to the lease components includes, apart from rent, those amounts that are not considered a separate component (e.g., INR 50,000 on account of property taxes and INR 30,000 on account of building insurance).

Discount rate to be used

Question 46

How does a lessee determine the discounting rate to be used to for calculating the present value of the lease payments for measuring the lease liability?

Response

Paragraph 26 of Ind AS 116 states as follows:

> "26 …The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."

Ind AS 116 defines interest rate implicit in the lease as, "the rate of interest that causes the present value of

(a) the lease payments and

(b) the unguaranteed residual value to equal the sum of

    (i) the fair value of the underlying asset and

    (ii) any initial direct costs of the lessor."

The interest rate implicit in the lease is likely to be equivalent to the lessee's incremental borrowing rate as both of them takes into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease term and initial direct costs of the lessor. In such cases, the interest rate implicit is not necessarily the rate stated in contract and in the absence of relevant information, the lessee may not in a position to readily determine the interest rate implicit in the lease. If interest rate implicit in the lease is not readily determinable by the lessee, the standard requires the lessee to use its incremental borrowing rate to discount the lease payments to their present value.

For example, Entity X enters into a lease agreement to lease an asset Z for a lease term of eight years. In that case, when determining its incremental borrowing rate for the lease, Entity X may consider the rate that Entity X has paid, or would pay, to borrow money to purchase the similar type of asset to 'asset Z' even with a longer life. However, Entity X would be required to adjust such observable rates as is needed to determine its incremental borrowing rate.

Lessee's incremental borrowing rate is defined as "the rate of interest that a 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." Thus, a lessee's incremental borrowing rate is specific to the entity and the particular lease.

Combining Contracts

Question 47

Entity X (lessee) entered into a lease agreement ('lease agreement') with Entity Y (lessor) to lease an entire floor of a shopping mall for a period of 9 years. The monthly lease rent is INR 70,000. To carry out its operations smoothly, Entity X simultaneously entered into another agreement ('facilities agreement') with Entity Y for using certain other facilities owned by Entity Y such as passenger lifts, DG sets, power supply infrastructure, parking space etc., which are specifically mentioned in the agreement, for monthly service charges amounting to INR 100,000. As per the agreement, the ownership of the facilities shall remain with Entity Y. Lessee's incremental borrowing rate is 10%.

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

Entity X has assessed that the stand-alone price of 'lease agreement' is INR 120,000 per month and stand-alone price of the 'facilities agreement' is INR 80,000 per month. Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component (s) from lease component(s) and accordingly it separates non-lease components from lease components.

Whether Entity X is required to combine both the agreements and account for them as a single contract? How will Entity X account for lease liability as at the commencement date?

Response

Paragraph B2 of Ind AS 116 states as follows:

> "In applying this Standard, an entity shall combine two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria is met:
>
> (a) the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together;
>
> (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract;
>
> (c) 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) form a single lease component…..".
>
> In accordance with the above, as the facility agreement is co-existent and co-terminus with lease agreement, is entered with the same counterparty (i.e., Entity Y), and both agreements are negotiated as a package, both agreements should be considered to be a single contract for accounting purposes.

Paragraph 13 of Ind AS 116 states as follows:

> "For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components."

Based on the above guidance, Entity X identifies that the contract contains lease of premises and non-lease component of facilities availed. As Entity X has not elected to apply the practical expedient as provided in paragraph 15, it will separate the lease and non-lease components and allocate the total consideration of INR 1,70,000 to the lease and non-lease components in the ratio of their relative stand-alone selling prices as follows:

Particulars	Stand-alone prices	% of total Stand-alone Price	Allocation of consideration
Building rent	1,20,000	60%	1,02,000
Service charge	80,000	40%	68,000
Total	**2,00,000**	**100%**	**1,70,000**

As Entity X's incremental borrowing rate is 10%, it discounts lease payments using this rate and the lease liability at the commencement date is calculated as follows:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A*B=C)
Year 1	1,02,000	0.91	92,820
Year 2	1,02,000	0.83	84,660
Year 3	1,02,000	0.75	76,500
Year 4	1,02,000	0.68	69,360
Year 5	1,02,000	0.62	63,240
Year 6	1,02,000	0.56	57,120
Year 7	1,02,000	0.51	52,020
Year 8	1,02,000	0.47	47,940
Year 9	1,02,000	0.42	42,840
Lease Liability at commencement date			**5,86,500**

Further, INR 68,000 allocated to the non-lease component of facility used will be recognised in profit or loss as and when incurred.

Contract Manufacturing

Question 48

A consumer products entity, Entity X (lessee) enters into a lease agreement with Entity Y for a dedicated production line to manufacture one of its store-brand household products for a period of three years. Entity X has agreed to order a minimum 100,000 units per month and to make a payment to Entity Y as per the following rate:

(i) INR 80 per unit if the ordered quantity is between 100,000 to 120,000 units.

(ii) INR 82 per unit if the ordered quantity is between 120,001 to 150,000 units.

As per the terms of agreement, Entity X has obtained the exclusive right to use of the production line and Entity Y cannot use the production line for other customer orders. The type of household product is specified in the contract. Entity X issues instructions to Entity Y about the quantity and timing of products to be delivered. If the production line is not producing the household product for Entity X, it does not operate. Entity Y operates and maintains the production line on a daily basis. Entity X has estimated that for manufacturing each unit, Entity Y incurs an average cost of INR 65. Further, the observable stand-alone price for rent of the production line is INR 20,00,000 per month. Entity X's incremental borrowing rate as at commencement date is 10%.

Entity X has concluded that the arrangement contains a lease as per Ind AS 116 and has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component (s) from lease component(s) and accordingly it separates non-lease components from lease components.

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

Response

Paragraph B42 of Ind AS 116 states as follows:

> "Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:
>
> (a) 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:

(i) 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

(ii) payments that are initially structured as variable lease 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) there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the realistic set of payments to be lease payments.

(c) 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 this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments."

Further, paragraphs 13 and 14 of Ind AS 116 state as follows:

> "13 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.
>
> 14 The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximising the use of observable information."

In the given case, the agreement contains a lease component (production line) and a non lease component (job work). As Entity X has not elected to apply the practical expedient as provided in paragraph 15, it will separate the lease and non-lease components and allocate the total consideration to the lease and non-lease components in the ratio of their relative stand-alone selling prices.

As Entity X is required to purchase a minimum of 1,00,000 units per month at the rate of INR 80 per unit, there is an in substance fixed payment of INR 80,00,000 per month –although the payments are structured as variable lease payments, there is no genuine variability in those payments as Entity X is required to purchase at minimum quantity 100,00 units per month, i.e., for INR 80,00,000 per month.

The observable stand-alone price for lease component (which is factory rent) is INR 20,00,000. The observable stand-alone price of non-lease component (which is job work charges) is 65,00,000 (INR 65*100,000 units).

Entity X is required to allocate the total consideration as follows:

Observable standalone price: Lease component	INR 20,00,000
Observable standalone price: Non-lease component	INR 65,00,000
Total	INR 85,00,000
Lease component as a percentage of observable prices	23.53%
Allocation of consideration to lease component (80,00,000*23.53%)	INR 18,82,400

The total allocation for a year will be INR 2,25,88,800 (18,82,400*12)

As Entity X's incremental borrowing rate is 10%, it discounts lease payments using this rate and the lease liability at the commencement date is calculated as follows:

Year	**Lease Payment (A)**	**Present value factor @ 10% (B)**	**Present value of lease payments (A*B=C)**
Year 1	2,25,88,800	0.91	2,05,55,808
Year 2	2,25,88,800	0.83	1,87,48,704
Year 3	2,25,88,800	0.75	1,69,41,600
Lease Liability at			**5,62,46,112**

commencement date

Entity X recognises lease liability amounting to INR 5,62,46,112 as at commencement date based on lease payments amounting to INR 18,82,400 per month. The remaining amount of INR 61,17,600 (80,00,000 - 18,82,400) which is attributable to job work charges is recognised in the statement of profit or loss as and when incurred.

Goods and Services Tax (GST)

Question 49

Entity X (lessee) enters into an agreement with Entity Y to lease an entire floor of a building for a period of 10 years. The annual lease payments are fixed at INR 30,00,000 and are required to be paid in advance. In addition, Entity X shall pay Goods and Services Tax (GST) at 18% to Entity Y, who will remit the tax to the applicable government. GST is non-refundable and Entity X cannot claim the input tax credit for the GST payment.

Whether the payment of GST is considered as a part of consideration paid by Entity X? How will Entity X account for the GST payments?

Response

Paragraph 17 of Ind AS 116 states as follows:

> "17 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73–90 of Ind AS 115."

Section 9(1) of the Central Goods and Services Tax Act, 2017 provides that, *"Subject to the provisions of sub-section (2), there shall be levied a tax called the central goods and services tax (CGST) on all intra-state supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined ...... and collected in such manner as may be prescribed and shall be paid by the taxable person".* Similar provisions are also included for State Goods and Services Tax Act (SGST), Integrated Goods and Services Tax Act (IGST) and Union Territory Goods and Services Tax Act (UGST)."

In accordance with the above, the incidence of GST (i.e. CGST/SGST/IGST/ UGST) is on supply of goods or services and it is recovered from the customer.

Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity. Therefore, they are excluded from revenue.

On the similar guidance, GST is a consumption based tax which is the liability of the lessee towards the Government. Although the same is paid by the lessee to the lessor, it cannot be considered as 'lease payment' since it is paid to the government and the lessor is merely acting as a collection agent. Therefore, GST, whether or not refundable, would not be included in the measurement of the lease liability or right-of-use asset.

Accordingly, Entity X will calculate lease liability based on the lease payments amounting to INR 30,00,000 per annum, i.e., excluding GST.

GST would be charged to the profit or loss when the underlying transaction occurs if input credit is not available. However, if GST is refundable/input credit is available, then GST is recognised as an asset.

Measurement of ROU asset and Lease liability in case of initial direct costs and lease incentives

Question 50

Entity X (lessee) enters into an agreement with Entity Y (lessor) to lease an entire floor of a building for a period of 10 years with an option to extend the lease for five years. At the commencement date, Entity X is not reasonably certain to exercise the option to extend the lease. Lease payments are INR 50,000 per year during the initial term and INR 55,000 per year during the optional period. As per the terms of contract, lease payments are required to be paid at the beginning of each year. To obtain the lease, Entity X incurred initial direct costs of INR 20,000, out of which INR 15,000 relates to a payment to a former tenant occupying that floor of the building and INR 5,000 relates to commission paid to the real estate agent that arranged the lease. As an incentive to Entity X for entering into the lease, Entity Y agrees to reimburse to Entity Y the real estate commission of INR 5,000. The interest rate implicit in the lease is not readily determinable by Entity X. Entity X's incremental borrowing rate is 10%.

How does Entity X initially recognise assets and liabilities in relation to the lease and account for initial direct costs and lease incentives?

Response

Paragraphs 24 and 26 of Ind AS 116 state as follows:

"24 The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;

(b) any lease payments made at or before the commencement date, less any lease incentives received;

(c) any initial direct costs incurred by the lessee; and

(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period."

"26 At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."

Ind AS 116 defines the terms 'lease incentives' and 'lease term' as follows:

Lease incentives

"Lease incentives are 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."

Lease term

"*The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:*

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) *periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option."*

As at the commencement date, Entity X is not reasonably certain to exercise the option to extend the lease and therefore the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Entity X's incremental borrowing rate is 10% p.a., which reflects the fixed rate at which it could borrow an amount similar to the value of the right-of use asset, in the same currency, for a period of 10 years.

At the commencement date, Entity X makes the lease payments for the first year, incurs initial direct costs, and receives lease incentive from Entity Y. Entity X will measure the lease liability at the present value of the remaining nine payments of INR 50,000 which will be discounted at the interest rate of 10% which is INR 2,87,500 as follows:

Year	Lease Payments (A)	PV@10% (B)	Present value of lease payments (A*B=C)
2	50,000	.91	45,500
3	50,000	.83	41,500
4	50,000	.75	37,500
5	50,000	.68	34,000
6	50,000	.62	31,000
7	50,000	.56	28,000
8	50,000	.51	25,500
9	50,000	.47	23,500
10	50,000	.42	21,000

Entity X will initially recognise right of use asset and liability in relation to the lease as follows:

ROU Asset........................Dr	3,37,500	
To Lease Liability		(2,87,500)
To Bank		(50,000)
ROU Asset.........................Dr	20,000	
To Cash (initial direct costs)		(20,000)

Cash (lease incentive).........Dr	5,000	
To ROU asset		(5,000)

Fair valuation of security deposit

Question 51

Lease arrangements generally have a clause whereby the lessee pays an agreed amount of money to the lessor as security deposit. How is such a security deposit to be dealt with?

Response

If the security deposit is non-refundable:

If the security deposit paid is non-refundable, then it is considered in the nature of a fixed lease payment and included in the lease rental schedule.

If the interest-free security deposit is refundable at the end of the lease term:

As per Ind AS 32 *Financial Instruments: Presentation*, *"A financial asset is any asset that is:*

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) ...."

In accordance with the above, refundable security deposit given by an entity is a financial instrument and should be classified as a financial asset in accordance with Ind AS 109, *Financial Instruments*.

Further, where the effect of time value of money is material, refundable security deposit should be discounted and should be shown at its present value at the time of its initial recognition. As regards the rate at which it should be discounted, the entity needs to evaluate the issue based on its own facts and circumstances taking into account the guidance as per Ind AS

109. In case of an interest free rent deposit paid to a lessor in respect of a non-cancellable lease arrangement, the difference between the present value of deposit and the amount of deposit paid may be deferred as prepaid rent to be recognised as an expense over the underlying lease term in accordance with Ind AS 116. Under Ind AS 116, such prepaid lease rental will be considered as part of lease payment but since it is already paid, it will form part of ROU asset but not lease liability.

Accounting of Interest-free Security deposit

Question 52

Entity X (lessee) entered into an agreement to take on lease a floor of building from Entity Y (lessor) for a period of 5 years. At commencement of lease, Entity X pays INR 10,00,000 as interest-free refundable security deposit to Entity Y to protect its (Y's) interest in the property. Entity X's effective interest rate is 10%. Entity X expects to obtain economic benefits from the right of use evenly over the term of the lease and accordingly amortises the right of use on a straight-line basis

How should Entity X account for interest-free deposit paid to Entity Y?

Response

As per Ind AS 32 *Financial Instruments: Presentation*, *"A financial asset is any asset that is:*

……….

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or."

Since as per the terms of contract, Entity X has contractual right to receive back the deposit from Entity Y at the end of the lease term, it meets the definition of financial asset.

Further, where the effect of time value of money is material, a refundable security deposit should be discounted and should be shown at its present value at the time of its initial recognition. Accordingly, in its financial statements, Entity X will recognise the deposit at its present value at the time of its initial recognition, i.e., at the time of lease commencement.

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A*B=C)
Year 5	10,00,000	0.62	6,20, 000
PV of security deposit as at commencement date			**6,20, 000**

Since the deposit is paid at the commencement of the lease, the difference between the present value of deposit and the amount of deposit paid will form the part of right of use asset and will be depreciated over the lease term.

Entity X accounts for the deposit as follows:

On the date of lease commencement:

Security Deposit........................Dr	6,20,000	
ROU asset…...........................Dr	3,80,000	
To Bank		(10,00,000)
Years 1 to Year 5		
Depreciation.........................Dr	76,000	
To ROU asset		(76,000)
Year 1		
Security Deposit........................Dr	62,092	
To Interest Income		(62,092)
Year 2		
Security Deposit........................Dr	68,301	
To Interest Income		(68,301)
Year 3		
Security Deposit........................Dr	75,131	
To Interest Income		(75,131)

Year 4		
Security Deposit.......................Dr	82,644	
To Interest Income		(82,644)
Year 5		
Security Deposit.......................Dr	90,909	
To Interest Income		(90,909)
At the end of 5 years		
Bank ....Dr	10,00,000	
To Security deposit		(10,00,000)

Security deposit paid in tranches

Question 53

Entity X enters into an agreement to take an office space on lease from Entity Y for a period of 10 years. As per the agreement, Entity X is required to deposit an interest-free refundable security amounting to INR 15,00,000 with Entity Y to protect Entity Y's interest in the property. This amount will be held by the Entity Y until the end of the lease term. The following are the payment terms for security deposit:

(i) INR 5,00,000 on signing of the contract

(ii) INR 5,00,000 at the end of year 1

(iii) INR 5,00,000 at the end of year 5.

The market rate of interest at lease commencement is 10% per annum.

How will Entity X account for the security deposit and the prepaid rent at commencement of the lease?

Response

As per Ind AS 32 *Financial Instruments: Presentation*, *"A financial asset is any asset that is:*

……….

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or."

Since as per the terms of contract, Entity X has contractual right to receive back the deposit from Entity Y at the end of the lease term, it meets the definition of financial asset.

Further, where the effect of time value of money is material, a refundable security deposit should be discounted and should be shown at their present value at the time of its initial recognition. Accordingly, in its financial statements, Entity X will recognise the deposit at its present value at the time of its initial recognition, i.e., at the time of lease commencement.

In accordance with the above, at commencement of the lease:

(i) Entity X is required to account for total security deposit amounting to INR 15,00,000 which will be measured at fair value amounting to INR 7,15,000 (Refer Note 1).

(ii) The difference between the transaction amount (INR 15,00,000) and the fair value (INR 715,000) amounting to INR 7,85,000 will form part of right of use (ROU) asset.

(iii) For the amount of deposit which is payable at the end of 1st and 5th year, Entity X recognises the same as other liabilities.

(iv) Entity X have paid security deposit amounting to INR 5,00,000 and has agreed to pay additional INR 10,00,000 in two equal installments at the end of 1st and 5th year.

The security deposit amounting to INR 5,00,000 is measured at fair value amounting to INR 1,95,000 (being present value of INR 5,00,000 for 10 years using market rate of interest at 10% p.a). The difference between the transaction amount and the fair value amounting to INR 3,05,000 will form part of ROU asset.

For the deposit payable at the end of 1st and 5th year, Entity X will recognise ROU asset amounting to INR 4,80,000 (being the difference between installment amount and present value of deposit) calculated using market rate of interest at 10% p.a.

At commencement date, the following accounting entries will be passed:

(i)	Security Deposit........................Dr	1,95,000	
	ROU Asset............................Dr	3,05,000	
	To Bank		(5,00,000)

(ii) Recognising ROU asset for the installments to be paid at the end of 1st year and 5th year:

ROU Asset............................Dr	4,80,000	
To Lease liability		(4,80,000)
In Year 1		
Lease liability........................Dr	2,90,000	
Security Deposit………………Dr	2,10,000	
To Bank		(5,00,000)
In Year 5		
Lease liability........................Dr	1,90,000	
Security Deposit……………… Dr.	3,10,000	
To Bank		(5,00,000)

Note 1: Calculation of present value of security deposit:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A*B=C)	Prepaid Asset (A-C)
Payments made on commencement date	5,00,000	0.39	1,95,000	3,05,000
Payments made at the end of 1st year	5,00,000	0.42	2,10,000	2,90,000
Payments made at the end of 5th year	5,00,000	0.62	3,10,000	1,90,000
PV of security deposit as at commencement date			**7,15,000**	**7,85,000**

Question 54

Entity X (lessee) enters into a property (land and building) lease with Entity Y (lessor). 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 INR 50 lakhs. Entity X has an option to purchase the property at the end of the lease term for INR 30 lakhs. The first annual payment is INR 5 lakhs with an increase of 3% every year thereafter. The interest rate implicit in the lease is 9.04%. Entity Y gives Entity X an incentive of INR 2 lakhs (payable at the beginning of year 2).

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

Response

Paragraph 27 (d) of Ind AS 116 states as follows:

> "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:
>
> (a)…
>
> (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option.

Paragraph 29 of Ind AS 116 states that-

> "After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies the measurement model described in paragraph 35"

Further, paragraphs 30 & 32 of Ind AS 116 state as follows:

> 30 "To apply a cost model, a lessee shall measure the right-of-use asset at cost:
>
> (a) less any accumulated depreciation and any accumulated impairment losses; and
>
> (b) adjusted for any remeasurement of the lease liability specified in paragraph 36(c).
>
> 32 "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 right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the useful life of the

right-of-use asset or the end of the lease term.

Paragraph 36 of Ind AS 116 states that-

"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 specified in paragraphs 39–46, or to reflect revised in-substance fixed lease payments (see paragraph B42).

In accordance with above, Entity X would first calculate the lease liability as the present value (PV) of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the interest rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (Refer Note 1)	INR 37,37,510
PV of purchase option at end of lease term (Refer Note 2)	INR 12,62,490
Total lease liability	**INR 50,00,000**

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

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

Right-of-use asset ……………Dr	INR 50,00,000	
To Lease liability		INR 50,00,000

Since the purchase option is reasonably certain to be exercised, Entity X would amortise the right-of-use asset over the useful life of the underlying asset (40 years). Annual amortisation expense would be INR 1,25,000 (INR 50,00,000 / 40 years). Although the lease was for 10 years, the asset had a useful life of 40 years. When Entity X 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.

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 Y and Entity X's purchase option.

Year	Payment	Principal paid	Interest paid	Interest expense	Lease Liability (end of the year
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,840	49,06,840
Year 2	3,15,000	-91,840 (3,15000-4,06,840)	4,06,840	4,15,143	50,06,983
Year 3	5,30,450	1,15,307	4,15,143	4,04,718	48,81,252
Year 4	5,46,364	1,41,645	4,04,718	3,91,912	47,26,800
Year 5	5,62,754	1,70,842	3,91,912	3,76,467	45,40,513
Year 6	5,79,637	2,03,170	3,76,467	3,58,098	43,18,974
Year 7	5,97,026	2,38,928	3,58,098	3,36,497	40,58,445
Year 8	6,14,937	2,78,440	3,36,497	3,11,324	37,54,832
Year 9	6,33,385	3,22,061	3,11,324	2,82,207	34,03,654
Year 10	6,52,387	3,70,180	2,82,207	2,48,739	30,00,000
Year 10	30,00,000	27,51,267	2,48,739	-	-
Total	**85,31,940**	**50,00,000**	**35,31,946**	**35,31,946**	

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

Year	Lease Payment (A)	Present value factor @ 9.04% (B)*	Present value of lease payments (A*B=C)
Year 1	5,00,000	1	5,00,000

Year 2	3,15,000 (5,15,000 – 2,00,000)	0.92	2,88,885
Year 3	5,30,450	0.84	4,46,142
Year 4	5,46,364	0.77	4,21,429
Year 5	5,62,754	0.71	3,98,085
Year 6	5,79,637	0.65	3,76,034
Year 7	5,97,026	0.59	3,55,204
Year 8	6,14,937	0.55	3,35,529
Year 9	6,33,385	0.50	3,16,897
Year 10	6,52,387	0.46	2,99,307
Total			**37,37,510**

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

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)*	Present value of purchase option (A*B=C)
Year 10	30,00,000	0.42	12,62,490
Total			**12,62,490**

***** For simplicity the Present value factor is rounded of upto two places, however the calculation is done as per exact value.

Subsequent Measurement

Question 55

In case the underlying asset belongs to a class of asset for which an entity has elected the revaluation model under Ind AS 16, *Property, Plant and Equipment,* how will the right of use asset be subsequently measured?

Response

Paragraph 35 of Ind AS 116 states as follows:

"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". [Emphasis added]

Paragraph 36 of Ind AS 16 states as follows:

"If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued."

Thus, the lessee may but not required to apply revaluation model to a class of right-of-use assets that relate to that class of property, plant and equipment

Impairment of ROU asset

Question 56

Entity X leases a machine for its manufacturing process over a non-cancellable 8-year period. The initial carrying value of the right of use (ROU) asset is INR 1 lakh, which is subsequently measured at cost and depreciated on a straight-line basis over a period of 8 years as it expects to obtain economic benefits from the right of use evenly over the term of the lease.

At the end of 4th year, the CGU that includes the ROU asset is impaired. An impairment charge of INR 10,000 is allocated to ROU asset. The carrying amount of the ROU asset before recognising the impairment charge is INR 50,000.

How will Entity X account for the impairment and measure the ROU asset and lease liability subsequently.

Response

Paragraph 33 of Ind AS 116 states as follows:

> "A lessee shall apply Ind AS 36, *Impairment of Assets*, to determine whether the right-of-use asset is impaired and to account for any impairment loss identified".

In the given case, the carrying value of the ROU asset immediately before the impairment amounts to INR 50,000. As per the above requirement, Entity X is required to recognise a charge of INR 10,000, and hence the carrying value of the ROU asset will be reduced to INR 40,000 and the future depreciation charge would be reduced to INR 10,000 per year (INR 40,000 over the remaining life of 4 years). However, there is no impact of impairment charge on lease liability.

ROU asset as at commencement date	1,00,000
Less: Depreciation for 4 years (using straight line basis) (12500*4)	(50,000)
ROU asset at the end of 4th year before impairment	**50,000**
Impairment charge	(10,000)
ROU Asset at the end of 4th year after impairment	**40,000**
Future annual depreciation charge for remaining 4 years (40,000/4)	10,000

Lease payments in foreign currency

Question 57

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

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

Response

On initial measurement, Entity X will measure the lease liability and ROU asset as under:

Year	Lease Payments (USD)	Present Value factor *@ 5%	Present Value of Lease Payment	Conversion rate (spot rate)	INR value
1	10,000	0.95	9,524	68	6,47,618
2	10,000	0.91	9,070	68	6,16,780
3	10,000	0.86	8,638	68	5,87,410

4	10,000	0.82	8,227	68	5,59,438
5	10,000	0.78	7,834	68	5,32,798
Total			**43,295**		**29,44,044**
*For simplicity the Present value factor is rounded of up to two places, however the calculation is done as per exact value.					

As per Ind AS 21, *The Effects of Changes in Foreign Exchange Rates,* monetary assets and liabilities are restated at each reporting date at the closing rate and the difference due to foreign exchange movement is recognised in profit and loss whereas non-monetary assets and liabilities carried measured in terms of historical cost in foreign currency are not restated.

Accordingly, the ROU asset in the given case being a non-monetary asset measured in terms of historical cost in foreign currency will not be restated but the lease liability being a monetary liability will be restated at each reporting date with the resultant difference being taken to profit and loss.

At the end of Year 1, the lease liability will be measured in terms of USD as under:

Lease Liability:

Year	Initial Value (USD)	Lease Payment	Interest @5%	Closing Value (USD)
1	43,295	10,000	2,165	35,460

Interest at the rate of 5% will be accounted for in profit and loss at average rate of INR 69 (i.e., USD 2,165 *69) = INR 1,49,385

Interest Expense………………Dr INR1,49,385

To Lease liability (INR 1,49,385)

Lease payment would be accounted for at the reporting date exchange rate, i.e. INR 70/- at the end of year 1

Lease liability………………………..Dr INR 700,000

To Cash INR 700,000

As per the guidance above under Ind AS 21, the lease liability will be restated using the reporting date exchange rate i.e., INR 70/- at the end of Year 1. Accordingly, the lease liability will be measured at INR 24,82,165 with the corresponding impact due to exchange rate movement of INR 88,736 (24,82,165 – (29,44,044 + 1,49,385 – 700,000) will be taken to profit and loss.

ROU asset will be measured during year 1 as follows:

Year	Opening Balance	Depreciation	Closing Balance
1	29,44,044	5,88,809	23,55,235

Variable lease payments dependent on an index

Question 58

Entity X (lessee) enters into an arrangement to lease a property for a period of 10 years. As per arrangement, the annual lease payments of INR 50,000 are payable at the beginning of each year. The arrangement specifies that lease payments will increase every two years on the basis of the increase in the Consumer Price Index (CPI) for the preceding 24 months. The Consumer Price Index at the commencement date is 125. The interest rate implicit in the lease is not readily determinable. Entity X expects to obtain economic benefits from the right of use evenly over the term of the lease and accordingly amortises the right of use on a straight-line basis.

Entity X's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Entity X could borrow an amount similar to the value of the right-of-use asset (ROU), in the same currency, for a 10-year term, and with similar collateral. At the beginning of the third year of the lease, the Consumer Price Index is 135.

How will Entity X measure its lease liability and ROU asset as at commencement date and subsequently?

Response

At the commencement date, Entity X makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of INR 50,000, discounted at the interest rate of 5 per cent per annum, which is INR 3,55,391.

Entity X initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset………………Dr	INR 4,05,391	
To Lease liability		(INR 3,55,391)
To Cash (lease payment for the first year)		(INR 50,000)

Entity X expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

During the first two years of the lease, Entity X recognises in aggregate the following related to the lease.

Interest expense………………Dr	INR 33,928	
To Lease liability		INR 33,928
Depreciation charge…………..Dr	INR 81,078	
(INR 4,05,391 ÷ 10 × 2 years)		
To Right-of-use asset		INR 81,078

At the beginning of the second year, Entity X makes the lease payment for the second year and recognises the following.

Lease liability………………..Dr	INR 50,000	
To Cash		INR 50,000

At the beginning of the third year, before accounting for the change in future lease payments resulting from a change in the Consumer Price Index and making the lease payment for the third year, the lease liability is INR 3,39,319 (the present value of eight payments of INR 50,000 discounted at the interest rate of 5 per cent per annum = INR 3,55,391 + INR 33,928 – INR 50,000).

The payment for the third year, adjusted for the Consumer Price Index, is INR 54,000 (INR 50,000 × 135 ÷ 125). Because there is a change in the future lease payments resulting from a change in the Consumer Price Index used to determine those payments, Entity X remeasures the lease liability to reflect those revised lease payments, i.e., the lease liability now reflects eight annual lease payments of INR 54,000.

At the beginning of the third year, Entity X remeasures the lease liability at the present value of eight payments of INR 54,000 discounted at an unchanged discount rate of 5 per cent per annum, which is INR 3,66,464.

Entity X increases the lease liability by INR 27,145, which represents the difference between the remeasured liability of INR 366,464 and its previous carrying amount of INR 339,319. The corresponding adjustment is made to the right-of-use asset as follows.

Right-of-use asset……………………Dr	INR 27,145	
To Lease liability		INR 27,145

Question 59

Scenario A: *Including cost of depreciation on right of use (ROU) asset & interest on lease liability in the cost of inventory*

Entity X (lessee) has taken a warehouse on lease where it stores its goods and also performs certain, grading, packaging and repackaging activity before the goods are shipped to its stores. Presently, Entity X capitalises the warehousing costs with its inventory considering they are costs incurred to bring the inventories in the condition as intended by the management. On application of Ind AS 116, Entity X will now recognise ROU asset and lease liability for this warehouse taken on lease. The warehouse is operating at its normal capacity.

Can the depreciation on the ROU asset and the interest on the lease liability be included in the cost of the inventories?

Scenario B: *Including cost of depreciation on ROU asset & interest on lease liability in the cost of machinery*

Entity X has taken a machine on lease which is being used to manufacture a heavy machinery for internal use which is expected to take a total of two years to manufacture. This machine is used by the Entity X in its production process. On application of Ind AS 116, the machine taken on lease will now be recognised as ROU asset and lease liability. Can Entity A include the depreciation on the ROU Asset and the interest on the lease liability in the cost of manufacturing the heavy machinery?

Response

The consequential amendment to Ind AS 23, *Borrowing Costs* amends the definition of borrowing costs to include interest in respect of lease liabilities recognised under Ind AS 116.

Paragraph 8 of Ind AS 23 states that an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them. Further, it defines a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Scenario A:

In the given scenario, the inventories of Entity X do not meet the definition of qualifying asset since they do not take a substantial period of time to get ready for their intended sale and hence, Entity X cannot capitalise the interest on the lease liability in the cost of the inventories.

However, the depreciation of the ROU asset is a cost necessary to bring the inventory in the condition to be readily available for sale and hence it should be included with the cost of the Inventory.

Scenario B:

As interest on lease liability is a borrowing cost, Entity X should capitalise it as a part of the cost of the property, plant and equipment, if it meets the definition of qualifying asset and other criteria in accordance with the requirements of Ind AS 23. Assuming 2 years is a substantial period of time, the machinery meets the definition of qualifying asset and accordingly, Entity A should capitalise the interest on the lease liability as part of cost of the property, plant and equipment.

There has been a consequential amendment of Ind AS 116 to Ind AS 16 which states that "the cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets".

Accordingly, in the given case, Entity X should include the depreciation on the ROU asset recognised for the machinery taken on lease used to manufacture the PPE in the cost of PPE.

Reassessment in lease liability due to change in lease term

Question 60:

Entity X (lessee) enters into an arrangement to lease a building floor for a period of 10 years and with an extension option for further 5 years. The principal terms of the contract are as follows:

(i) The lease payments are to be made in advance at the beginning of each year.

(ii) During the basic lease term, the lease payments are INR 5 lakhs per year.

(iii) During the extension period (if opted), the lease payments would be INR 5.5 lakhs per year.

Initial direct costs incurred by Entity X are INR 2 lakhs.

Entity X is initially not reasonably certain to exercise the extension option. The incremental borrowing rate of Entity X is 10% p.a.

At the end of year 6, Entity X negotiates the lease for another floor (in addition to the existing floor) in the same building at an arm's length price due to a business acquisition which is likely to result in the existing floor becoming insufficient for the entity's needs. For this purpose, Entity X concludes a separate eight-year lease for an additional floor in the building. The floor would be available for use from the end of year 7.

Incremental borrowing rate at the end of year 6 is 11 % p.a. Entity X expects to obtain economic benefits from the right of use evenly over the term of the lease and accordingly amortises the right of use on a straight-line basis.

How will Entity A account for the aforesaid changes?

Response

Paragraph 40 of Ind AS 116 states as follows:

> "A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:
>
> (a) there is a change in the lease term, as described in paragraphs 20–21. A lessee shall determine the revised lease payments on the basis of the revised lease term; or
>
> (b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20–21 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

Further, paragraph 44 of Ind AS 116 states as follows:

> "A lessee shall account for a lease modification 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand—alone price to reflect the circumstances of the particular contract."

In accordance with above, in the given case, the relocation of staff taken on in the business acquisition to the same building presents the lessee with an economic incentive to use the extension option. The acquisition is a significant event that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise the extension option which was not previously included in its determination of the lease term.

The original floor has a greater value in use for the lessee (and thus a greater benefit) than an alternative asset as additional costs would arise from a relocation or employees would be distributed across different buildings.

Entity X, thus concludes at the end of year 6 that it is reasonably certain that it will exercise the extension option. Thus, the lease liability and right of use (ROU) asset for the original lease will be modified and the calculation is as follows; the lease for the additional floor will be treated as separate lease.

The ROU asset and the lease liability were as follows in years 1 to 6:

Year	Lease Liability				ROU Asset		
	Initial value	Lease payments	Interest expense @ 10%	Closing balance	Initial Value	Depreciation	Closing balance
1	28,79,512 (Refer Note 1)	-	2,87,951	31,67,463	35,79,512 (Refer Note 2)	3,57,951	32,21,561
2	31,67,463	5,00,000	2,66,746	29,34,209	32,21,561	3,57,951	28,63,610
3	29,34,209	5,00,000	2,43,421	26,77,630	28,63,610	3,57,951	25,05,658
4	26,77,630	5,00,000	2,17,763	23,95,393	25,05,658	3,57,951	21,47,707
5	23,95,393	5,00,000	1,89,539	20,84,933	21,47,707	3,57,951	17,89,756
6	20,84,933	5,00,000	1,58,493	17,43,426	17,89,756	3,57,951	14,31,805

Before the change in lease term, the lease liability using the original discount rate of 10% p.a. comes to INR 17,43,426. The lessee's right of use asset at that date is INR 14,31,805/-.

Lease liability is remeasured, including four payments of INR 500,000 and five payments of INR 550,000, discounted at a rate of 11% p.a. The present value is INR 32,08,182 (Refer note 3).

The lessee increases the lease liability by INR 14,64,756/-, which is the difference between the remeasured lease liability of INR 32,08,182 and the previous carrying value of INR 17,43,426/-. Due to remeasurement, the carrying amount of the lessee's ROU asset is INR 28,96,561 (INR 14,31,805 + INR 14,64,756). At the beginning of year 7, the lessee calculates the interest expense for the lease liability at the changed interest rate of 11% p.a.

The ROU asset and the lease liability will be as follows in years 7 to 15:

Year	Lease Liability				ROU Asset		
	Initial value	Lease payments	Interest expense @ 11%	Closing balance	Initial Value	Depreciation	Closing balance
7	32,08,182	5,00,000	2,97,900	30,06,082	28,96,561	3,21,840	25,74,720
8	30,06,082	5,00,000	2,75,669	27,81,751	25,74,720	3,21,840	22,52,880
9	27,81,751	5,00,000	2,50,993	25,32,743	22,52,880	3,21,840	19,31,040
10	25,32,743	5,00,000	2,23,602	22,56,345	19,31,040	3,21,840	16,09,200
11	22,56,345	5,50,000	1,87,698	18,94,043	16,09,200	3,21,840	12,87,360
12	18,94,043	5,50,000	1,47,845	14,91,888	12,87,360	3,21,840	9,65,520
13	14,91,888	5,50,000	1,03,608	10,45,495	9,65,520	3,21,840	6,43,680
14	10,45,495	5,50,000	54,505	5,50,000	6,43,680	3,21,840	3,21,840
15	5,50,000	5,50,000	-	-	3,21,840	3,21,840	-

Note 1: Calculating PV of remaining lease payments using original discount rate of 10% p.a.:

Year	Lease Payment (A)	Present value factor @ 10% (B)*	Present value of lease payments (A*B=C)
Year 1	5,00,000	0.91	4,54,545
Year 2	5,00,000	0.83	4,13,223
Year 3	5,00,000	0.75	3,75,657
Year 4	5,00,000	0.68	3,41,507
Year 5	5,00,000	0.62	3,10,461
Year 6	5,00,000	0.56	2,82,237
Year 7	5,00,000	0.51	2,56,579
Year 8	5,00,000	0.47	2,33,254
Year 9	5,00,000	0.42	2,12,049
Total			**28,79,512**
*For simplicity the Present value factor is rounded of upto two places, however the calculation is done as per exact value.			

Note 2: Calculating initial value of ROU Asset:

Particulars	**Amount**
Initial Value of Lease liability (As per Note 1)	28,79,512
Add: First lease payment already paid	5,00,000
Add: Initial direct costs	2,00,000
Initial Value of ROU Asset	**35,79,512**

Note 3: Calculating PV of revised lease payments using discount rate of 11% p.a.:

Year	Lease Payment (A)	Present value factor @ 11% (B)*	Present value of lease payments (A*B=C)
Year 1	5,00,000	1.00	5,00,000
Year 2	5,00,000	0.90	4,50,450
Year 3	5,00,000	0.81	4,05,811
Year 4	5,00,000	0.73	3,65,596
Year 5	5,50,000	0.66	3,62,302
Year 6	5,50,000	0.59	3,26,398
Year 7	5,50,000	0.53	2,94,052
Year 8	5,50,000	0.48	2,64,912

Year 9	5,50,000	0.43	2,38,660
Total			**32,08,182**
*For simplicity the Present value factor is rounded of upto two places, however the calculation is done as per exact value.			

Question 61

Entity X (lessee) enters into an arrangement to lease an office space measuring 5,000 sq. ft. The annual lease rentals are paid in arrears amounting to INR 5,00,000. Lessee's incremental borrowing rate at commencement date is 12% p.a. At the beginning of year 6, the lease agreement is amended to reduce the leased space to 3000 sq. ft. On account of reduction in space, annual lease rentals are also reduced (from year 6 to year 10) to INR 3,50,000. Lessee's incremental borrowing rate at beginning of year 6 is 10% p.a.

How would Entity X account for the modification of lease?

Response

Paragraph 44 of Ind AS 116 states as follows:

> "A lessee shall account for a lease modification 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract."

Further, paragraphs 45 and 46 of Ind AS 116 states as follows:

45 For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:

(a) allocate the consideration in the modified contract applying paragraphs 13–16;

(b) determine the lease term of the modified lease applying paragraphs 18–19; and

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

"46. For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications."

Since the conditions of paragraph 44 above are not met, the lease modification will not be accounted as a separate lease. In accordance with paragraph 46(a) above, Entity X shall remeasure the lease liability (at the beginning of year 6) on the basis of:

a) a remaining residual lease term of 5 years;

b) annual lease payments of INR 3,50,000; and

c) an incremental borrowing rate of 10% p.a.

Year	Lease Payment (INR) (A)	Present value factor @ 10% (B)*	Present value of lease payments (A*B=C)
Year 6	3,50,000	0.91	3,18,182
Year 7	3, 50,000	0.83	2,89,256
Year 8	3, 50,000	0.75	2,62,960
Year 9	3, 50,000	0.68	2,39,055
Year 10	3, 50,000	0.62	2,17,322
Total			**13,26,775**
* For simplicity the Present value factor is rounded of upto two places, however the calculation is done as per exact value			

New present value of the lease obligation is INR 13,26,775. The proportionate reduction of the contract (40% liability and 40% right of use (ROU) asset) results in net gain.

In years 1 to 5, the lease liability and ROU asset are calculated as follows:

Year	Lease Liability				ROU Asset		
	Opening balance/initial value	**Lease payments**	**Interest expense @ 12%**	**Closing balance**	**Opening balance/initial value**	**Depreciation**	**Closing balance**
1	28,25,112	5,00,000	3,39,013	26,64,125	28,25,112	2,82,511	25,42,600
2	26,64,125	5,00,000	3,19,695	24,83,820	25,42,600	2,82,511	22,60,089
3	24,83,820	5,00,000	2,98,058	22,81,878	22,60,089	2,82,511	19,77,578
4	22,81,878	5,00,000	2,73,825	20,55,704	19,77,578	2,82,511	16,95,067
5	20,55,704	5,00,000	2,46,684	18,02,388	16,95,067	2,82,511	14,12,556

(Refer note 1 for calculation of Initial value of ROU asset and lease liability)

i) 40% of the ROU asset immediately before the modification (INR 14,12,556) is INR 5,65,022.

ii) 40% of the lease liability immediately before the modification (INR 18,02,388) is INR 7,20,955.

Based on the above, income of INR 1,55,933 (INR 7,20,955 – INR 5,65,022) is recognised at the beginning of year 6 in profit and loss.

Difference between remaining old lease liability INR 10,81,433 (INR 18,02,388 - INR 7,20,955)and the new lease liability of INR 13,26,775 results in a commensurate increase in carrying amount of ROU asset.

Note 1: Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 12% (B)*	Present value of lease payments (A*B=C)
Year 1	5,00,000	0.89	4,46,429
Year 2	5,00,000	0.80	3,98,597
Year 3	5,00,000	0.71	3,55,890
Year 4	5,00,000	0.64	3,17,759
Year 5	5,00,000	0.57	2,83,713
Year 6	5,00,000	0.51	2,53,316
Year 7	5,00,000	0.45	2,26,175
Year 8	5,00,000	0.40	2,01,942
Year 9	5,00,000	0.36	1,80,305
Year 10	5,00,000	0.32	1,60,987
Total			**28,25,112**
*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.			

Lease modification – considered as a separate lease

Question 62

Entity X (lessee) enters into an arrangement with Entity Y (lessor) to lease 2,000 square metres of office space for a period of 10 years. At the beginning of Year 6, Entity X and Entity Y agree to amend the original lease for the remaining 5 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 Entity X 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 Entity X receives reflecting that Entity Y does not incur costs that it would otherwise have incurred in leasing the same space to a new tenant (for example, marketing costs). Will the lease modification be treated as a separate lease?

Response

Paragraph 44 of Ind AS 116 states as follows:

> "A lessee shall account for a lease modification 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract."

Entity X accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Entity X 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 the given case, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (the end of the second quarter of Year 6), Entity X recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Entity X 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.

Lease modification – reduction in lease term

Question 63

Entity X (lessee) enters into an arrangement to lease an office space measuring 2,000 sq. ft. for a period of 10 years. Entity X makes the annual lease payments of INR 100,000 p.a. in arrears. The lessee's incremental borrowing rate at the commencement of the lease is 10% p.a.

Entity X enters into a lease modification at beginning of year 6 whereby the total term of the contract is reduced from 10 to 8 years.

The annual lease payments for the space measuring 2,000 sq. ft. remains unchanged at INR 100,000 p.a. The lessee's incremental borrowing rate at beginning of year 6 is 11% p.a.

How will Entity X account for the changes in the terms of the lease?

Response

Paragraphs 44, 45 and 46 of Ind AS 116 state as follows:

> "44 A lessee shall account for a lease modification 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand—alone price to reflect the circumstances of the particular contract.
>
> 45 For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:
>
> (a) allocate the consideration in the modified contract applying paragraphs 13–16;
>
> (b) determine the lease term of the modified lease applying paragraphs 18–19; and
>
> (c) remeasure the lease liability by discounting the revised lease

payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications."

In accordance with the above paragraphs, in the given case, the lease modification does not amount to a separate lease.

The right of use (ROU) asset and the lease liability immediately before the modification has been determined as follows:

Year	Lease Liability				ROU Asset		
	Opening balance /initial value	**Lease payments**	**Interest expense**	**Closing balance**	**Opening balance/ initial value**	**Depreciation**	**Closing balance**
1	6,14,456	1,00,000	61,446	5,75,902	6,14,457	61,446	5,53,011
2	5,75,902	1,00,000	57,590	5,33,493	5,53,011	61,446	4,91,565
3	5,33,493	1,00,000	53,349	4,86,842	4,91,565	61,446	4,30,120
4	4,86,842	1,00,000	48,684	4,35,526	4,30,120	61,446	3,68,674
5	4,35,526	1,00,000	43,553	3,79,079	3,68,674	61,446	3,07,228
6	3,79,079				3,07,228		

(Refer note 1 for calculation of Initial value of ROU asset and lease liability)

After the modification (at the beginning of year 6), the lessee remeasures the lease liability with remaining lease term of 3 years and incremental borrowing rate of 11%.

Year	Lease Payment (A)	Present value factor @ 11% (B)*	Present value of lease payments (A*B=C)
Year 6	1,00,000	0.90	90,090
Year 7	1,00,000	0.81	81,162
Year 8	1,00,000	0.73	73,119
Total			**2,44,371**
*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.			

The changed lease liability comes to INR 2,44,371.

Entity X accounts for modification of lease on account of change in lease term in the following manner:

ROU asset	
Before lease modification (see the workings above)	3,07,228
After lease modification -for the remaining term which is reduced from 5 to 3 years	(1,84,337)
(INR 3,07,228 ÷ 5 × 3 years)	
Difference in ROU asset on account of reduction in lease term	1,22,891
Lease liability	
Before lease modification (see the workings above)	3,79,079
New PV calculated from 3 payments of INR 1,00,000/- discounted at the original interest rate of 10% p.a. (Refer note 2).	(2,48,685)
Difference in lease liability on account of reduction in lease term	1,30,394

Income accounted at the beginning of year 6 on account of reduction in lease term amounts to INR 7,503/- (INR 1,30,394- INR 1,22,891).

The incremental borrowing rate has increased from 10% to 11%. The effect of an increase in the interest rate from 10% to 11% on the lease liability amounts to INR 4,314 (INR 2,48,685 - INR 244,371) and is recognised as an adjustment of the ROU asset.

Entity X shall account following relevant accounting entries:

Particulars	Debit	Credit
Lease Liability………………………………Dr	1,30,394	-
To gain on lease modification	-	7,503
To ROU asset	-	1,22,891
(Being net income accounted at the beginning of 6th year)		
Lease Liability……………………………...Dr	4,314	-
To ROU asset	-	4,314
(Being effect of revised incremental borrowing rate adjusted in ROU asset)		

Note 1: Calculation of Initial value of ROU asset and lease liability

Year	Lease Payment (A)	Present value factor @ 10% (B)*	Present value of lease payments (A*B=C)
Year 1	100000	0.91	90,909.09
Year 2	100000	0.83	82,644.63
Year 3	100000	0.75	75,131.48
Year 4	100000	0.68	68,301.35
Year 5	100000	0.62	62,092.13
Year 6	100000	0.56	56,447.39
Year 7	100000	0.51	51,315.81
Year 8	100000	0.47	46,650.74
Year 9	100000	0.42	42,409.76
Year 10	100000	0.39	38,554.33
Total			**6,14,456.71**

*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.

Note 2: Calculation of present value for remaining 3 payments discounted at the original interest rate of 10% p.a

Year	Lease Payment (A)	Present value factor @ 10% (B)*	Present value of lease payments (A*B=C)
Year 6	1,00,000	0.91	90,909.09
Year 7	1,00,000	0.83	82,644.63
Year 8	1,00,000	0.75	75,131.48
Total			**2,48,685.20**
*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.			

Lease modification – change in consideration only

Question 64

Entity X (lessee) enters into an arrangement with Entity Y (lessor) to lease 5,000 sq. ft. of office space for a period of 10 years. The interest rate implicit in the lease cannot be readily determined. Entity X's incremental borrowing rate at the commencement date is 10 per cent per annum.

At the beginning of Year 6, Entity X and Entity Y agree to amend the original lease for the remaining five years to reduce the lease payments from INR 100,000 per year to INR 95,000 per year. Entity X's incremental borrowing rate at the beginning of Year 6 is 12 per cent per annum. The annual lease payments are payable at the end of each year.

How would Entity X account for the modification of lease?

Response

Paragraphs 44-46 of Ind AS 116 state as follows:

> " 44 A lessee shall account for a lease modification 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand—alone price to reflect the circumstances of the particular contract.

45 For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:

(a) allocate the consideration in the modified contract applying paragraphs 13–16;

(b) determine the lease term of the modified lease applying paragraphs 18–19; and

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

"46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

In accordance with the above paragraphs, in the given case, the lease modification does not amount to a separate lease.

The right of use (ROU) asset and the lease liability immediately before the modification have been determined as follows:

Year	Lease Liability				ROU Asset		
	Opening balance/initial value	Lease payments	Interest expense	Closing balance	Opening balance /initial value	Depreciation	Closing balance
1	6,14,457 (Refer Note 1)	1,00,000	61,446	5,75,903	6,14,457	61,446	5,53,011
2	5,75,903	1,00,000	57,590	5,33,493	5,53,011	61,446	4,91,565
3	5,33,493	1,00,000	53,349	4,86,842	4,91,565	61,446	4,30,120
4	4,86,842	1,00,000	48,684	4,35,526	4,30,120	61,446	3,68,674
5	4,35,526	1,00,000	43,553	3,79,079	3,68,674	61,446	3,07,228
6	3,79,079				3,07,228		

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

(a) a five-year remaining lease term;

(b) annual payments of INR 95,000; and

(c) its incremental borrowing rate of 12 per cent per annum.

Year	Lease Payment (A)	Present value factor @ 12% (B)*	Present value of lease payments (A*B=C)
Year 6	95,000	0.89	84,821
Year 7	95,000	0.80	75,733
Year 8	95,000	0.71	67,619
Year 9	95,000	0.64	60,374
Year 10	95,000	0.57	53,906
Total			**3,42,454**
*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.			

Entity X recognises the difference of INR 36,625/- between the carrying amount of the modified liability amounting to INR 3,42,454 and the lease liability immediately before the modification amounting to INR 3,79,079 as an adjustment to the right-of-use asset.

Note 1: Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A*B=C)
Year 1	1,00,000	0.91	90,909
Year 2	1,00,000	0.83	82,645
Year 3	1,00,000	0.75	75,131
Year 4	1,00,000	0.68	68,301
Year 5	1,00,000	0.62	62,092

Year 6	1,00,000	0.56	56,447
Year 7	1,00,000	0.51	51,316
Year 8	1,00,000	0.47	46,651
Year 9	1,00,000	0.42	42,410
Year 10	1,00,000	0.39	38,554
Total			**6,14,457**

*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.

Initial direct costs in a lease modification

Question 65

Entity X (lessee) enters into an arrangement to lease an office space measuring to 5,000 sq. ft. for a period of 10 years. The annual lease payments amounting to INR 5 lakhs are paid in arrears. Entity X's incremental borrowing rate at commencement date is 12% p.a.

At beginning of year 6, the lease agreement is amended by mutual consent to increase the leased space by 2000 sqft. On account of increase in space, annual lease payments also increase (from year 6 to year 10) to INR 6.5 lakhs. Entity X also pays stamp duty amounting to INR 50,000 on increased leased space.

The consideration for the additional space of lease is not commensurate with the stand-alone price for the additional space. Hence, Entity X is required to account for the increased scope of the lease as a modification of the original lease and not as a separate lease.

The lessee's incremental borrowing rate at beginning of year 6 is 10% p.a.

How would Entity X account for the initial direct costs (stamp duty) on modification of lease?

Response

Scenario A:

The accounting for initial direct costs on lease modification is not dealt with in Ind AS 116. However, entities might consider drawing analogy to accounting of initial direct costs as at commencement date and apply similar accounting on modification date.

Paragraph 24(c) of Ind AS 116, *inter alia* states that "the cost of the right-of-use asset shall comprise any initial direct costs incurred by the lessee".

Lessees and lessors may account for costs incurred in a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that meet the definition of initial direct costs in the same manner as those items are accounted for in connection with a new lease.

A lessee's initial direct costs in a lease modification are included in the measurement of the new right-of- use asset (i.e., for a modification that is accounted for as a separate contract) or the adjustment to the right-of-use asset (i.e., for a modification that is not accounted for as a separate contract).

Drawing analogy to accounting of initial direct costs as at commencement date, Entity X may adjust stamp duty paid on modification in the carrying amount of the right-of-use asset.

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

(a) a five-year remaining lease term

(b) annual payments of INR 6,50,000 and

(c) Lessee's incremental borrowing rate of 10% p.a.

As the consideration for the additional space of lease of 2000 sq ft is not commensurate with the stand-alone price for the increase in space, Entity X accounts for the increased scope as a modification of the original lease and not as a separate lease.

The modified lease liability equals INR 24,64,011 (refer note 1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 5) is INR 18,02,388 (refer note 2). Entity X 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., INR 6,61,623) (refer note 3) as an adjustment to the ROU Asset. Entity X also accounts the stamp duty paid on modification as an adjustment to ROU asset (refer note 3).

Note 1: Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 10% (B)*	Present value of lease payments (A*B=C)
Year 6	6,50,000	0.91	5,90,909
Year 7	6,50,000	0.83	5,37,190
Year 8	6,50,000	0.75	4,88,355
Year 9	6,50,000	0.68	4,43,959
Year 10	6,50,000	0.62	4,03,599
Modified lease liability			**24,64,011**
*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.			

Note 2: Lease liability and ROU asset immediately before modification date

Year	Lease liability				ROU Asset		
	Opening	**Interest expense (@12%)**	**Lease payment**	**Closing**	**Opening**	**Depreciation charge**	**Closing**
1	28,25,112 (refer working below)	3,39,013	(5,00,000)	26,64,125	28,25,112	2,82,511	25,42,600
2	26,64,125	3,19,695	(5,00,000)	24,83,820	25,42,600	2,82,511	22,60,089
3	24,83,820	2,98,058	(5,00,000)	22,81,878	22,60,089	2,82,511	19,77,578
4	22,81,878	2,73,825	(5,00,000)	20,55,704	19,77,578	2,82,511	16,95,067
5	20,55,704	2,46,684	(5,00,000)	18,02,388	16,95,067	2,82,511	14,12,556
6	18,02,388				14,12,556		

Year	Lease Payment (A)	Present value factor @ 12% (B)*	Present value of lease payments (A*B=C)
Year 1	5,00,000	0.89	4,46,429
Year 2	5,00,000	0.80	3,98,597
Year 3	5,00,000	0.71	3,55,890
Year 4	5,00,000	0.64	3,17,759
Year 5	5,00,000	0.57	2,83,713
Year 6	5,00,000	0.51	2,53,316
Year 7	5,00,000	0.45	2,26,175
Year 8	5,00,000	0.40	2,01,942
Year 9	5,00,000	0.36	1,80,305
Year 10	5,00,000	0.32	1,60,987

Lease liability as at commencement date	**28,25,112**

*For simplicity, the present value factor as shown here is rounded off upto two places; however the calculation of present value is done as per exact value.

Note 3: Lease liability and ROU asset immediately before modification date

Modified Lease liability	24,64,011
Original Lease liability as at modification date	18,02,388
Adjustment to ROU asset	**6,61,623**
ROU asset as at Modification date (Refer Note 2)	14,12,556
Add: Adjustment on modification	6,61,623
Add: Stamp duty paid	50,000
Revised ROU asset as at Modification	**21,24,179**

Accounting by Lessor

Recognition and Measurement: Finance lease

Question 66

Entity Y (lessor) enters into an arrangement for lease of an equipment with Entity X (lessee) for a period of 10 years. The equipment is not specialised in nature and is expected to have alternative use to Entity Y at the end of the 10-year lease term. The following information is relevant:

(i) Entity Y is to receive annual lease payments of INR 15,000 at the end of the year.

(ii) Entity Y expects the residual value of the equipment to be INR 50,000 at the end of the lease term.

(iii) Entity X provides a residual value guarantee that protects Entity Y from the first INR 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., INR 50,000).

(iv) At the time the arrangement is entered into, the equipment has an estimated remaining useful life of 15 years.

(v) At the time the arrangement is entered into, the carrying amount of the equipment in the books of the lessor is INR 100,000 and it has a fair value of INR 1,11,000.

(vi) The lease does not transfer ownership of the underlying asset to Entity X at the end of the lease term.

(vii) The lease does not contain an option for the lessee to purchase the underlying asset nor does it contain any renewal or extension or termination option.

(viii) The interest rate implicit in the lease is 10.078%.

Entity Y considers the lease as a finance lease under Ind AS 116.

How are the net investment in the lease and the allocation of interest income over the lease term are required to be accounted for Entity Y? Further, how is net investment in lease measured if the Entity Y subsequently assesses that the estimated residual value has increased from INR 50,000 to INR 75,000?

Response

Paragraph 67 of Ind AS 116 states as follows:

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

Further, paragraph 70 of Ind AS 116 states as follows-

> "At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:
>
> (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable;
>
> (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
>
> (c) 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;
>
> (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and
>
> (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease."

In the given case, at lease commencement, Entity Y accounts for the lease as follows:

To record the net investment in the lease and derecognise the underlying asset:

Net investment in the lease...........Dr	100,000 (see note i)	
To Equipment held for lease		100,000(see note ii)

Note (i) The net investment in the lease consists of:

- the present value of the 10 annual lease payments of INR 15,000 plus the present value of the guaranteed residual value of INR 30,000, both discounted at the interest rate implicit in the lease, which equals INR 103,344 (i.e., the lease receivable), plus

- the present value of unguaranteed residual value of INR 20,000, which equals INR 7,656, less
- deferred selling profit of INR 11,000.

(*Deferred selling profit is calculated as the lease receivable of INR 103,344 less the carrying amount of the underlying asset of INR 100,000, net of unguaranteed residual value of INR 7,656.)*

It may be mentioned that the net investment in the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent assets in the balance sheet.

Note (ii) INR 100,000 is the carrying amount of the underlying asset.

Year 1 Journal entries for the lease:

Cash……………………Dr	15,000 (see Note a)	
To Net investment in the lease		2,825 (see Note b)
To Interest income		12,175 (see Note c)

Notes:

(a) Receipt of annual lease payment at the end of the year.

(b) Reduction of the net investment in the lease for lease payment received of INR 15,000, net of interest income of INR12,175.

(c) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease.

The following table summarises the interest income for the lease and the related amortisation of the net investment over the lease term.

Year	Annual rental payment	Annual Interest Income (see Note a)	Net Investment at the end of the year
Initial Net Investment			1,00,000

Year 1	15,000	12,175	97,175
Year 2	15,000	11,831	94,006
Year 3	15,000	11,445	90,451
Year 4	15,000	11,012	86,464
Year 5	15,000	10,527	81,991
Year 6	15,000	9,982	76,973
Year 7	15,000	9,371	71,345
Year 8	15,000	8,686	65,031
Year 9	15,000	7,917	57,948
Year 10	15,000	7,055	50,000 (see Note b)

Notes:

(a) Interest income includes interest on the lease receivable, accretion of the unguaranteed residual value and amortisation of deferred selling profit. The rate for recognising interest income to produce a constant periodic rate of return on the remaining net investment is 12.175%.

(b) The estimated residual value of the equipment at the end of the lease term.

The following table summarises the components of interest income recognised over the lease term.

Year	**Interest on lease receivable (a)**	**Accretion of unguaranteed residual asset (b)**	**Amortization of deferred selling profit (c)**	**Annual interest income**
Year 1	10,415	772	988	12,175
Year 2	9,954	849	1,028	11,831
Year 3	9,445	935	1,065	11,445
Year 4	8,885	1,029	1,098	11,012
Year 5	8,269	1,133	1,125	10,527
Year 6	7,590	1,247	1,145	9,982

Year 7	6,843	1,373	1,156	9,371
Year 8	6,021	1,511	1,154	8,686
Year 9	5,117	1,663	1,137	7,917
Year 10	4,119	1,831	1,105	7,055

(a) Interest on the lease receivable is based on the interest rate implicit in the lease of 10.078%. For example, Year 1 interest on the lease receivable is calculated as the lease receivable of INR 1,03,344 multiplied by the interest rate implicit in the lease of 10.078%.

(b) Accretion of the unguaranteed residual asset is based on the interest rate implicit in the lease of 10.078%. For example, Year 1 accretion of the residual value is calculated as the present value of the unguaranteed residual value at lease commencement of INR 7,656 multiplied by the interest rate implicit in the lease of 10.078%.

(c) Deferred selling profit is amortised into interest income over the lease term in a manner that, when combined with the interest income on the lease receivable and unguaranteed residual asset, produces a constant periodic rate of return on the lease of 12.175%.

Paragraph 77 of Ind AS 116 states that 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.

In accordance with the above, on change in the estimate of unguaranteed residual value from INR 50,000 to INR 75,000, Entity Y shall recalculate its net investment in lease using revised residual value and adjust the same over the remaining lease term.

Lessor accounting – operating lease

Question 67

Entity Y (the lessor) enters into an operating lease agreement with Entity X (the lessee) for an office space. The term of the lease agreement is three years. The lease rental is fixed at INR 20,000 per month for the first year, with an escalation adjustment of 6% at the end of years 1 and 2. Therefore, the lease rentals payable are fixed as follows:

Year 1: INR 20,000 per month

Year 2: INR 21,200 per month

Year 3: INR 22,472 per month

Entity Y assesses that based on practice in the local area, these annual escalations reflect the potential increases in general inflation index over the period of the lease agreement.

How will the above payments be accounted for by Entity Y?

Response

Paragraph 81 of Ind AS 116 states as follows-

"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 from the use of the underlying asset is diminished".

In accordance with above paragraph, in the given case, the fixed annual increases in lease payments are part of the minimum lease payments and are spread on a straight-line basis over the lease term. The amounts are not discounted. Entity Y recognises a monthly rental income of INR 21,224 which is the average of the three years' lease payments even though the escalations reflect the expected increase in general inflation index.

Accounting for lease incentives

Question 68

How will Entity Y account for the incentive in the following scenarios?

Scenario A:

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of INR 1,10,000. In order to induce Entity X to enter into the lease, Entity Y provides INR 600,000 to Entity X at lease commencement for lessee improvements (i.e., lessee assets).

Scenario B:

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of INR 1,10,000. At lease commencement, Entity Y provides INR 600,000 to Entity X for leasehold improvements which will be owned by Entity Y (i.e., lessor's assets). The estimated useful life of leasehold improvements is 5 years.

Response

Paragraphs 70 and 71 of Ind AS 116 state as follows-

> "70 At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:
>
> (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable;
>
> (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
>
> (c) 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;
>
> (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and
>
> (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.
>
> 71 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 from the use of the underlying asset is diminished."

Scenario A

In accordance with above, in the given case, at lease commencement, Entity Y accounts for the incentive as follows:

To account for the lease incentive:

Deferred lease incentive)..........Dr INR 600,000

To Cash INR 600,000

Recurring monthly journal entries in Years 1–5 as follows:

To record cash received on account of lease rental and amortisation of lease incentive over the lease term:

Cash	Dr	INR 110,000	
To Lease income			INR 100,000
To Deferred lease incentive			INR 10,000 (see Note a)

Note (a): This is calculated as INR 600,000 ÷ 60 months.

Scenario B

Entity Y has provided lease incentive amounting to INR 6,00,000 to Entity X for leasehold improvements in the premises. As Entity Y has the ownership of the leasehold improvements carried out by the lessee, it shall account for the same as property, plant & equipment and shall depreciate the same over its useful life.

In accordance with above, in the given case, at lease commencement, Entity Y accounts for the incentive as follows:

To record the lease incentive:

Property, plant & Equipment	Dr	INR 600,000	
To Cash			INR 600,000

Recurring monthly journal entries in Years 1–5 as follows:

To record cash received on account of lease rental over the lease term:

Cash	Dr	INR 110,000	
To Lease income			INR 110,000

To record depreciation on PPE over the lease term using straight line method:

Depreciation	Dr	INR 10,000	
To Accumulated Depreciation			INR 10,000

Sublease classification

Question 69

In the following scenarios, what would be the accounting in the books of Entity X (intermediate lessor)?

Scenario A: *Classification as Finance lease*

Head lease: Entity X (intermediate lessor) enters into a lease with Entity Y (head lessor) to take on lease office space of 5,000 sq. ft. for a 10-year period (head lease).

Sublease: At the beginning of year 6, Entity X leases out the office space of 5,000 sq. ft. to a third party (sub lessee) for the remaining 5 years of the head lease.

Scenario B: *Classification as operating lease*

The facts are the same as above except that the sublease has a term of 3 years instead of 5 years.

Response

Paragraph 62 of Ind AS 116 states as follows:

> "A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset".

Further, paragraph 63 provides following examples of situations that leads to a lease being classified as finance lease:

(a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the underlying 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;

(c) the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;

(d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and

(e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

Paragraph B58 of Ind AS 116 states as follows:

In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

(a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 6, the sublease shall be classified as an operating lease.

(b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease).

Scenario A

In the given scenario, the intermediate lessor classifies the sublease as a finance lease, taking into account the requirements of above paragraphs.

If an intermediate lessor enters into an intermediate finance lease, it should

– derecognise the right-of-use asset under the head lease which it transfers to the sub lessee,

– recognise the net investment in the sublease as an asset,

– recognise the difference between the right-of-use asset and the net investment as a gain or loss, and

– continue to recognise the lease liability, i.e., the lease payments owed to the head lessor, for the head lease.

Over the sublease term, the intermediate lessor recognises the interest income from the sublease and the interest expense for the head lease.

Scenario B

In the given scenario, the intermediate lessor classifies the sublease as an operating lease, taking into account the requirements of above paragraphs.

If an intermediate lessor enters into an intermediate lease, it continues to recognise the lease liability and the right-of-use asset under the head lease. Over the sublease term, the intermediate lessor recognises the amortization expense on the right-of-use asset and the interest expense for the lease liability; and income from the sublease.

Lessor's accounting for lease modifications: Finance leases

Question 70

Entity X (lessee) entered into a contract with Entity Y (lessor) to lease an office equipment for a period of 5 years.

The following table summarises information about the lease and the leased assets at lease inception.

Lease term	5 years; no renewal option held by either party
Economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	INR 1,95,000
Payment date	Annually on April 1
Fair value of the leased equipment	INR 12,00,000
Entity Y's carrying amount of the leased equipment	INR 12,00,000
Estimated residual value at the end of 5 years	INR 4,00,000
Residual value guarantee at the end of 5 years	INR 3,00,000 residual value guarantee is provided by a third party unrelated to Entity X or Entity Y
Interest rate charged in the lease	5%
Other	Title to the asset remains with Entity Y

At lease commencement, Entity Y concluded that the lease is a finance lease because it transfers substantially all the risks and rewards incidental to ownership of an underlying asset to lessee Therefore, Entity Y initially recognised a net investment in the lease of INR 12,00,000 and derecognised the carrying value of the equipment of INR 12,00,000.

At the end of year 1 of the lease, Entity X and Entity Y agree to modify the lease to shorten the lease term by two years. The relevant information at the modification date is shown in the following table.

Modification date	Beginning of year 2
Remaining modified lease term	2 years; no renewal option held by either party
Remaining economic life of the leased equipment	7 years
Purchase option	None
Annual lease payments	INR 1,90,000
Payment date	Annually on April 1
Fair value of the leased equipment	INR 10,00,000
Entity Y's carrying amount of net investment in the lease on the modification date	INR 10,55,201 (interest income of INR 50,201 was recorded in the first year of the lease)
Estimated residual value at the end of next 2 years	INR 7,00,000
Residual value guarantee at the end of next 2 years	INR 3,50,000 residual value guarantee is provided by a third party unrelated to Entity X or Entity Y
Interest Rate implicit in the modified lease	5.43%

The modified lease consideration is at a discount to the current market rate for the additional term for this particular lease contract.

How would Entity Y account for the lease modification?

Response

Paragraph 79 of Ind AS 116 states as follows:

> "A lessor shall account for a modification to a finance lease 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 stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Further, paragraph 80 of Ind AS 116 states as follows:

> "For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:
>
> (a) if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:
>
> (i) account for the lease modification as a new lease from the effective date of the modification; and
>
> (ii) measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
>
> (b) otherwise, the lessor shall apply the requirements of Ind AS 109.

In accordance with above, Entity Y accounts for the lease modification as below:

(i) Determine if the lease modification is to be accounted for as a separate new lease

Since there is no increase in scope of lease, Entity Y would not account for the modification as a new lease, separate from the original five-year lease. Entity Y would account for a single, modified lease as at the beginning of year 2.

(ii) Reassess lease classification based on the terms of the modified lease

Entity Y would classify the modified lease as an operating lease because it does not transfer substantially all the risks and rewards incidental to ownership of the underlying asset.

(iii) Account for the modified lease

Entity Y would account for the modified lease by derecognising the net investment in the lease of INR 10,55,201 and recognising the equipment at the same amount. If collectability of the lease payments is probable, Entity Y would recognise the remaining lease payments on a straight-line basis over the two-year modified lease team and record depreciation on the equipment.

Lessor's accounting for lease modifications: Operating leases

Question 71

Entity X (lessee) enters into an arrangement with Entity Y to lease 10,000 square feet of office space for a period of 10 years. The annual lease payments are INR 100,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The economic life of office space is 40 years. The lease term is not for a major part of the remaining economic life of the office space (40 years), and the present value of the lease payments is not substantially all of the fair value of the office space. Furthermore, the title does not transfer to Entity X as a consequence of the lease and the lease does not contain an option for Entity X to purchase the office space. Besides, the asset is not specialised such that it clearly has an alternative use to Entity Y at the end of the lease term. Thus, on a holistic evaluation of the terms of the lease, Entity Y determines that it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset. Accordingly, the lease is classified by Entity Y as an operating lease.

At the beginning of Year 6, Entity X and Entity Y agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for an additional annual fixed payment of INR 150,000. The modified lease continues to be classified as an operating lease.

How would Entity Y account for the modification in the lease contract?

Response

Paragraph 87 of Ind AS 116 states as follows:

"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".

In accordance with above paragraph, Entity Y shall account for the modification in the lease contract as follows:

(i) Determine if the lease modification is to be accounted for a separate new lease

Because the change in pricing of the lease is not commensurate with the stand-alone price for the additional right-of-use asset, Entity Y does not account for the modification as a new lease, separate from the original 10-year lease.

(ii) Account for the modified lease

Entity Y accounts for the modified lease prospectively from the effective date of the modification, recognising the lease payments to be made under the modified lease of INR 750,000 (INR 150,000 × 5 years), net of Entity Y's accrued rent asset of INR 76,331 (refer note 1), on a straight-line basis over the remaining 5-year lease term, i.e.

INR 673,669 ÷ 5 years = INR 134,734 per year

At the end of the lease, Entity Y will have recognised as lease income the INR 13,02,564 in lease payments it receives from lessee during the 10-year lease term.

Note 1

At the effective date of the modification (the beginning of Year 6), Entity Y has an accrued lease rental asset of INR 76,331 as follows:

Rental income recognised on a straight-line basis for the first 5 years of the lease [see (a) below]	628,895
Less: Lease payments received for the first 5 years [see (b) below]	552,564
	76,331

(a) INR 1,257,789 ÷ 10 years = INR 125,779 per year * 5

(b) Lease payments for the first 5 years

(i) Year 1- INR 1,00,000

(ii) Year 2- INR 1,05,000

(iii) Year 3- INR 1,10,250

(iv) Year 4- INR 1,15,763

(v) Year 5- INR 1,21,551

Total INR 5,52,564

Year	Annual rental payment (A)	Straight lining of rent income (B)	Accrued lease rental asset recognised during the year (C=B–A)
Year 1	100,000	1,25,779	25,779
Year 2	105,000	1,25,779	20,779
Year 3	110,250	1,25,779	15,529
Year 4	115,763	1,25,779	10,016
Year 5	121,551	1,25,779	4,228
Year 6	127,628	1,25,779	-1,849
Year 7	134,010	1,25,779	-8,231
Year 8	140,710	1,25,779	-14,931
Year 9	147,746	1,25,779	-21,967
Year 10	155,132	1,25,779	-29,354
Total	**1,257,789**	12,57,790	**-**

Accrued lease rental at the beginning of 6th year is INR 76,331 (25,779 + 20,779 + 15,529 + 10,016 + 4,228).

Presentation and Disclosure by Lessee

Question 72

Whether an entity is required to classify its right of use assets and lease liabilities as current and non-current if they relate to short-term leases?

Response

Paragraph 5 of Ind AS 116 provides an exemption for short-term leases, i.e. leases with a term of less than 12 months, and allows carrying them off-balance sheet. However, an entity may decide not to avail the said exemption and recognise right-of-use assets and related lease liabilities on balance sheet. In such a case, the classification of short-term leases on the balance sheet will be as follows:

Classification of lease liabilities

Where lease liabilities relate to short-term leases, the entity would have an obligation and the liability is due to be settled within twelve months after the reporting period. As such, following the requirements of paragraph 69 of Ind AS 1, *Presentation of Financial Statements,* such liabilities should be classified as current.

Classification of right-of-use assets

According to paragraph 66 of Ind AS 1, an asset is classified as current if an entity expects to realise it, or intends to sell or consume it, in its normal operating cycle or expects to realise the asset within 12 months after the reporting period. By definition, the term of a short-term lease is less than 12 months. Hence, the right-of-use asset meets the criterion in paragraph 66 of Ind AS 1 and should be classified as current.

However, paragraph 47(a) of Ind AS 116 allows an entity to disclose right-of-use assets within the same line item in balance sheet line as that within which the corresponding underlying assets would be presented if they were owned. The term ‘property, plant and equipment’ is defined under paragraph 6 of Ind AS 16, *Property, Plant and Equipment* as tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one period. Considering that the right-of-use assets for short-term leases are not expected to be used during more than one period, they do not meet the definition of property, plant and equipment and accordingly, should be classified as a current asset. This classification of the right-of-use asset would also align with the classification of the lease liability.

Further, the current/non-current classification of right-of-use assets related to leases other than short term leases should be consistent with principles applied to classification of property, plant and equipment. Property, plant and equipment is always presented as non-current even if at the reporting date it is expected to be realised/consumed/sold within 12 months (unless criteria for classification for held-for-sale as per Ind AS 105, *Non-Current Assets held for Sale and Discontinued Operations* are met). As such, right-of-use assets related to leases other than short term leases should be presented as non-current.

Question 73

Entity X has elected to apply the short-term lease measurement and recognition exemption to its office equipment. Until 28 February of Year 1, there were only two short-term leases in that class. However, on 1 March of Year 1, Entity X enters into 20 new lease agreements for office equipment and they all qualify for the short-term lease measurement and recognition exemption. The short-term lease expense for the reporting period ending 31 March of Year 1 is INR 10,00,000, but the total short term lease payments for the following year are expected to be INR 2,00,00,000. Whether Entity X is required to disclose the fact that the short-term lease payments will significantly increase in the following year?

Response

Paragraph 51 of Ind AS 116 states as follows:

> "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. Paragraphs 52–60 specify requirements on how to meet this objective."

Paragraph 59 of Ind AS 116 states as follows:

> "In addition to the disclosures required in paragraphs 53–58, a lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 51 (as described in paragraph B48). This additional information may

include, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessee's leasing activities;

(b) future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:

   (i) variable lease payments (as described in paragraph B49);

   (ii) extension options and termination options (as described in paragraph B50);

   (iii) residual value guarantees (as described in paragraph B51); and

   (iv) leases not yet commenced to which the lessee is committed.

(c) restrictions or covenants imposed by leases; and

(d) sale and leaseback transactions (as described in paragraph B52)."

Based on the disclosure objectives and requirements of Ind AS 116, Entity X should consider disclosing INR 2,00,00,000 commitment because the short-term lease expense of INR 10,00,000 recorded in the current period does not reflect its short-term lease commitments at the end of reporting period.

Question 74

Whether an entity is required to disclose depreciation charge for right-of-use assets as a separate line item in the statement of profit and loss?

Response

Paragraph 49 of Ind AS 116 states as follows:

> "In the statement of profit and loss, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. 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 and loss."

Paragraph 53 further states as follows:

"A lessee shall disclose the following amounts for the reporting period:

(a) depreciation charge for right-of-use assets by class of underlying asset;

(b) ….

(c) ….

(d) ….

(e) ….

(f) ….

(g) …."

There is no specific requirement under the Standard to disclose depreciation on right of use asset as a separate line item in statement of profit and loss. Accordingly, to meet the above requirements, a lessee may present the depreciation charge for right-of-use assets in the same line item/items in which similar expenses (e.g. depreciation and amortisation charge) are shown in the statement of profit and loss.

It may be noted, however, that as per the requirements of paragraph 85 of Ind AS 1, an entity may have to present depreciation on right-of-use assets separately as additional line item when such presentation is relevant to an understanding of the entity's financial performance.

In either case, the depreciation charge for right-of-use assets by class of underlying asset must be disclosed (by way of a separate line item or in the notes to the financial statements) in accordance with paragraph 53 of Ind AS 116.

Question 75

How should a lessee present variable lease payments which are not included in measurement of lease liabilities in the statement of profit and loss?

Response

Ind AS 116 defines variable lease payments as 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. Paragraph 53(e) of Ind AS 116 requires a lessee to disclose the expense relating to variable lease payments not included in the measurement of lease liabilities. Ind AS 116 does not specify how an entity should present such variable lease payments in the statement of profit and loss. An entity may present variable lease payments relating to right of use asset as lease rental in the statement of profit and loss.

Question 76

How is the lease of a building (that does not qualify as investment property) classified in the balance sheet if an entity elects not to present right-of-use asset in a separate line item?

Response

Paragraph 47 of Ind AS 116 provides that a lessee shall present a right-of-use asset in the balance sheet either in a separate line item or in the same line item in which the corresponding underlying asset would have been presented if it had been owned, with a disclosure of which line item includes the right-of-use asset. Thus, a right-of-use asset resulting from the lease of a building that is not presented in a separate line item on the balance sheet should be classified as property, plant and equipment. The amount of right of use asset included in the line item of property, plant and equipment needs to be disclosed in the notes to the financial statements.

Question 77

How should an entity classify lease payments in the statement of cash flows?

Response

Paragraph 50 of Ind AS 116 requires an entity to make the following classifications within statement of cash flows:

Cash flows from operating activities	• Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability
Cash flows from financing activities	• Cash payments for the principal portion of the lease liability
	• Cash payments for the interest portion of the lease liability applying the requirements in Ind AS 7, *Statement of*

Cash Flows, for interest paid

Further, an entity is required to disclose the initial recognition of the lease at commencement as a non-cash transaction.

Question 78

How should an entity record gain/loss on termination of lease?

Response

When a lease is terminated in its entirety, there should be no remaining lease liability or right-of-use asset. As per paragraph 46 of Ind AS 116, the lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease. Thus, the difference between the carrying amounts of the right-of-use asset and the lease liability should be recorded in the statement of profit or loss as a gain or loss and such gain or loss should be shown under 'other income'/'other expense'.

Question 79:

How will lease liability be presented under segment reporting?

Response

Ind AS 108, *Operating Segments*, requires disclosure of segment information to be based on information reported to the chief operating decision maker (CODM) for the purpose of making decisions about allocation of resources to the segment and for assessing its performance. Accordingly, disclosure is required of a measure of assets and a measure of liabilities for each reportable segment, if they are provided to the CODM. Therefore, if a lease arrangement pertains to a reportable segment, then the lease liability will be included as part of such reportable segment along with related depreciation on right-of-use asset and interest on lease liability.

Presentation & Disclosure by Lessor

Question 80

Is an intermediate lessor permitted to offset the remaining lease liability for the head lease and the lease receivable from the sublease?

Response

Paragraph B58 of Ind AS 116 states as follows:

> "In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:
>
> (a) ………
>
> (b) … the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease)."

Since the lessor of the sublease is, at the same time, the lessee with respect to the head lease, it will in any case have to recognise an asset on its balance sheet – a right-of-use asset with respect to the head lease (if the sublease is classified as an operating lease) or a lease receivable with respect to the sublease (if the sublease is classified as a finance lease).

For a sublease that results in a finance lease, the intermediate lessor is not permitted to offset the remaining lease liability for the head lease and the lease receivable from the sublease. The same is also true for the lease income and lease expense relating to the head lease and sublease of the same underlying asset.

Question 81

How should income relating to variable lease payments in respect of a finance lease be presented by a lessor in the statement of profit and loss?

Response

Paragraph 90 of Ind AS 116 states as follows:

> "A lessor shall disclose the following amounts for the reporting period:
>
> (a) for finance leases:
>
> (i) selling profit or loss;
>
> (ii) finance income on the net investment in the lease; and
>
> (iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.
>
> (b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend

on an index or a rate.”

Thus, as per paragraph 90 of Ind AS 116, there is no specific requirement to disclose variable lease payments as a separate line item in the statement of profit and loss. However, paragraph 85 of Ind AS 1, *Presentation of Financial Statements* states as follows:

> “An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of the entity’s financial performance

In order to meet the requirements of paragraph 85 of Ind AS 1, a lessor may have to present income relating to variable lease payments separately as additional line item in the statement of profit and loss when such presentation is relevant to an understanding of the entity’s financial performance.

Question 82

How should a lessor present payments made directly to the relevant authority by the lessee for property tax and insurance in the statement of profit and loss where obligation to pay property tax is that of the lessor?

Response

Any payments that the lessee makes for property taxes and insurance that are lessor’s obligations should be presented in the statement of profit and loss as revenue and expense. For example, if the lessee makes a payment of INR 100,000 directly to the relevant authority for property tax, the lessor should record income of INR 100,000 and property tax expense of INR 100,000.

Transitional Provisions

Question 83

On 1 April 2016, Company X (lessee) entered into an arrangement with Entity Y to lease a piece of equipment for a period of 10 years and, in the process, it incurred INR 5,000 of initial direct costs in the form of commissions, which were expensed under Ind AS 17, *Leases*. The lease was previously classified as an operating lease under Ind AS 17. As per the lease agreement, Company X is required to pay the lessor INR 10,000 on 1 April of each year. The lease does not contain any termination, extension or purchase options. The interest rate implicit in the lease is 12% as on 1 April

2016. Company X's incremental rate of borrowing as of 1 April 2019 is 10%. Company X has transitioned to Ind AS 116 on 1 April 2019. The following additional information is also relevant:

- The contract meets the definition of a lease under both Ind AS 17 and Ind AS 116.
- The lease does not qualify for low value or short-term lease exemption under Ind AS 116.
- Company X will use the cost model within Ind AS 16, *Property, Plant and Equipment* to amortise the right-of-use asset recognised by it under Ind AS 116.

Evaluate the impact on transition date under all three transition approaches specified under Ind AS 116.

Response

Step1:

Measurement of lease liability: By applying full retrospective approach

The lease liability (PV of future cash flows) by applying full retrospective approach will be calculated as follows.

Date of payment	Lease rent pay-out (INR)	PV Factor (discount rate - 12%)	PV (INR)
1 April 2016	10,000	1	10,000
1 April 2017	10,000	0.8929	8,929
1 April 2018	10,000	0.7972	7,972
1 April 2019	10,000	0.7118	7,118
1 April 2020	10,000	0.6355	6,355
1 April 2021	10,000	0.5674	5,674
1 April 2022	10,000	0.5066	5,066
1 April 2023	10,000	0.4523	4,523
1 April 2024	10,000	0.4039	4,039
1 April 2025	10,000	0.3606	3,606

	100,000		63,282

Note:

1. *If the interest rate implicit in the lease were not readily determinable, the lessee's incremental rate of borrowing at commencement date would have been used.*

Measurement of lease liability – By applying modified approach

Under both approaches 1 and 2, present value of lease liability will be the same. The lease liability (PV of future cash flows) will be calculated as follows:

Date of payment	Lease rent payout (INR)	PV Factor (Discount rate- 10%)	PV (INR)
1 April 2019	10,000	1	10,000
1 April 2020	10,000	0.9091	9,091
1 April 2021	10,000	0.8264	8,264
1 April 2022	10,000	0.7513	7,513
1 April 2023	10,000	0.6830	6,830
1 April 2024	10,000	0.6209	6,209
1 April 2025	10,000	0.5645	5,645
	70,000		**53,553**

Note: The discount rate under the modified retrospective approach is always the lessee's incremental rate of borrowing as at the date of initial application even if the interest rate implicit in the lease is readily determinable.

Step 2: Measurement of ROU under the three approaches

A. Full retrospective approach

FY	Opening balance	Amortisation charge	Closing balance
2016-2017	68,282*	6,828	61,454
2017-2018	61,454	6,828	54,626

2018-2019	54,626	6,828	47,797

* Initial direct costs plus lease liability = 5,000 + 63,282= 68,282

B. Modified retrospective approach 1

Under the modified retrospective approach 1, the ROU at commencement date is equal to lease liability i.e. INR 53,553

C. Modified retrospective 2:

Under the modified retrospective approach 2, present value of ROU should be calculated from lease commencement date. See the below table for measurement of ROU (PV of future cash flows)

Date of payment	Lease rent Payout (INR)	PV Factor (Discounting rate-10%)	PV (INR)
1 April 2016	10,000	1	10,000
1 April 2017	10,000	0.9091	9,091
1 April 2018	10,000	0.8264	8,264
1 April 2019	10,000	0.7513	7,513
1 April 2020	10,000	0.6830	6,830
1 April 2021	10,000	0.6209	6,209
1 April 2022	10,000	0.5645	5,645
1 April 2023	10,000	0.5132	5,132
1 April 2024	10,000	0.4665	4,665
1 April 2025	10,000	0.4241	4,241
	100,000		**67,590**

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Financial Year	Opening balance	Amortisation charge	Closing balance
2016-2017	67,590	6,759	60,831
2017-2018	60,831	6,759	54,072

2018-2019	54,072	6,759	47,313

Step 3: Evaluating impact under all approach

	Full retrospective	**Modified retrospective 1**	**Modified retrospective 2**
Lease liability:			
Fixed payments	63,282	53,553	53,553
Certain variable payments	-	-	-
Residual value guarantee	-	-	-
Exercise price of purchase option	-	-	-
Termination penalty	-	-	-
Total Lease liability	**63,282**	**53,553**	**53,553**
Right of use asset			
Lease liability (as on lease commencement date i.e. 1 April 2016)	63,282		67,590
Initial direct costs	5,000		[1]-
Cost of removal and restoration	-		-
Less : lease incentives	-		-
Right of use asset (A)	**68,282**	**53,553**	**67,590**

Impact on equity on date of initial application

Right of use asset (A)	**68,282**	**53,553**	**67,590**
3 year depreciation **(B)**	20,484	-	20,277
ROU on March 2019 C = (A-B)	**47,797**	**53,553**	**47,313**
Lease liability 1 April 2019 (D)	51,114*	53,553*	53,553*
Adjustment to Equity E = C - D	**(3,317)**	**0**	**(6,240)**

* Refer unwinding of lease liability calculation

[1] Entity X has decided to use the practical expedient that excludes initial direct cost from the measurement of right of use asset at the date of initial application.

Unwinding of lease liability

The lease liability control account is then projected forward in the usual way to determine its carrying amount at each relevant balance sheet date.

Full retrospective approach

Dates of payment	Lease rent payout	Opening balance	Interest at 12%	Closing balance
1 April 2016	10,000	53,282*	6,394	59,676
1 April 2017	10,000	49,676	5,961	55,638
1 April 2018	10,000	45,638	5,477	51,114
1 April 2019	10,000	41,114	4,934	46,048
1 April 2020	10,000	36,048	4,326	40,373
1 April 2021	10,000	30,373	3,645	34,018
1 April 2022	10,000	24,018	2,882	26,901
1 April 2023	10,000	16,901	2,028	18,929
1 April 2024	10,000	8,929	1,071	10,000
1 April 2025	10,000	-	-	-

* Opening balance lease amount equals total liability less paid on day 1, i.e., 63,282-10,000=53,282

Modified retrospective approaches 1 & 2

Dates	Lease rent payout	Opening balance net of payment	Interest at 10%	Closing balance
01-04-2019	10,000	43,553*	4,355	47,908
01-04-2020	10,000	37,908	3,791	41,699
01-04-2021	10,000	31,699	3,170	34,869
01-04-2022	10,000	24,869	2,487	27,355
01-04-2023	10,000	17,355	1,736	19,091
01-04-2024	10,000	9,091	909	10,000
01-04-2025	10,000	-	-	-

*Opening balance lease amount equals total liability less paid on day 1, i.e., 53,553-10,000=43,553

Question 84

On 1 April 2016, Company X commenced the construction of its office premise, which was expected to take five years to complete at an estimated cost of INR 6,00,00,000. The Company took a crane under an operating lease arrangement (within the meaning of Ind AS 17) for period of 5 years on a rental charge of 15,00,000 per annum and recognised the same as lease rental expenses till FY 2018-2019. Company X's incremental rate of borrowing at lease commencement date is 12%. During the financial year 2019 -2020, Entity X transitions to Ind AS 116, applying Ind AS 116 fully retrospectively. Whether portion of operating lease cost which is required to be capitalised as per Ind AS 116 can be capitalised in building cost retrospectively? Also, prepare opening balance sheet (relating to the above lease only) as on 1 April 2019, i.e. the date of transition to Ind AS 116.

Response

Entity X will capitalise interest expenses retrospectively in office premises as per consequential amendment to Ind AS 23, *Borrowing Costs* which provides that borrowing costs includes interest in respect of lease liabilities recognised in accordance with Ind AS 116. Similarly, as per Ind AS 16, *Property, Plant and Equipment,* depreciation of ROU asset will be capitalised in office premises as a directly attributable cost.

Calculating lease liability under Ind AS 116 following full retrospective approach:

Years	Payments	Present value factor	Present value
2016-2017	15,00,000	0.8929	13,39,286
2017-2018	15,00,000	0.7972	11,95,791
2018-2019	15,00,000	0.7118	10,67,670
2019-2020	15,00,000	0.6355	9,53,277
2020-2021	15,00,000	0.5674	8,51,140
Total		**54,07,164**	

Unwinding of lease liability over tenure of lease

Years	Opening balance	Interest	Payments	Closing balance
2016-2017	54,07,164	6,48,860	15,00,000	45,56,024

2017-2018	45,56,024	5,46,723	15,00,000	36,02,747
2018-2019	36,02,747	4,32,330	15,00,000	25,35,077
2019-2020	25,35,077	3,04,209	15,00,000	13,39,286
2020-2021	13,39,286	1,60,714	15,00,000	-

Transition date adjustment:

Right of Use (ROU)

Particular	Amount
ROU as on April 2016	54,07,164
Less: Amortisation of ROU for 3 year as per SLM method (54,07,164/5)*3	32,44,299
ROU asset as on 1 April 2019	21,62,865

Lease liability

Particular	Amount
Opening balance of lease liability as on 1 April 2016	54,07,164
Add: Interest for FY 2016-17, 2017-18 and 2018-19 (6,48,860 + 5,46,723 + 4,32,330)	16,27,912
Less: Lease rent payments	45,00,000
Opening balance of Lease liability as on 1 April 2019	25,35,076

Adjustment on date of transition

Particular	Amount
Amortisation of ROU	32,44,299
Plus: Interest (6,48,860 + 5,46,723 + 4,32,330)	16,27,912
Amount capitalised in qualifying asset	48,72,210
Less: Reversal of lease rent booked till 1 April 2019	45,00,000
Adjustment to PPE (qualifying asset)	372,211

Balance Sheet as on 1 April 2019

Liability	Amount	Asset	Amount
earnings Lease liability (54,07,164-28,72,087)	25,35,077	ROU (54,07,164-32,44,298)	21,62,866

		PPE – as qualifying asset (32,44,299 +16,27,912-45,00,000)	372,211
Total	25,35,077	Total	25,35,077

Question 85

Entity X took a building on operating lease on 1 April 2013, for tenure of 5 years with an option to renew it for further 10 years. On initial recognition of lease, Entity X was not reasonably certain that it would exercise this option and so the lease term was initially taken as 5 years. However, on 1 April 2018, Entity X exercised its option of renewal for another 10 years.

At the inception of lease (1 April 2013), the lease rentals were INR 100,000 per annum. The lease rentals are paid in advance at start of each year including lease commencement date (i.e. 1 April 2013). The lease rentals are subject to a 25% escalation on expiry of every five years.

Entity X has decided to apply modified retrospective approach whereby lease liability will be measured as on 1 April 2019 and ROU will be measured on lease commencement date. Entity X's incremental rate of borrowing as on 1 April 2019 is 11.5%.

Calculate the lease liability in accordance with Ind AS 116 at the transition date.

Response

As per clause (e) of paragraph C10 of Appendix C of Ind AS 116, a lessee can use hindsight to determine lease term if the contract contains option to extend or terminate the lease. Based on option provided by the Standard, lease liability can be calculated in either of the two ways:

(a) The entity avails the practical expedient of using hindsight to determine lease tenure, or

(b) the entity does not avail the practical expedient of using hindsight to determine lease tenure.

Option 1: Entity avails the practical expedient of using hindsight to determine lease tenure. In this case, the lease term is taken as 15 years as on 1 April 2013.

Calculation of ROU

S. No	Lease payment dates	Lease rent outflow	PV Factor	Present value
0	01-04-13	1,00,000	1.0000	1,00,000
1	01-04-14	1,00,000	0.8969	89,686
2	01-04-15	1,00,000	0.8044	80,436
3	01-04-16	1,00,000	0.7214	72,140
4	01-04-17	1,00,000	0.6470	64,699
5	01-04-18	1,25,000	0.5803	72,533
6	01-04-19	1,25,000	0.5204	65,052
7	01-04-20	1,25,000	0.4667	58,343
8	01-04-21	1,25,000	0.4186	52,325
9	01-04-22	1,25,000	0.3754	46,928
10	01-04-23	1,56,250	0.3367	52,610
11	01-04-24	1,56,250	0.3020	47,184
12	01-04-25	1,56,250	0.2708	42,318
13	01-04-26	1,56,250	0.2429	37,953
14	01-04-27	1,56,250	0.2178	34,039
			ROU	9,16,247

ROU amortisation table:

Dates	Opening balance	Depreciation	Closing balance
31-03-14	9,16,247	61,083	8,55,163
31-03-15	8,55,163	61,083	7,94,080
31-03-16	7,94,080	61,083	7,32,997
31-03-17	7,32,997	61,083	6,71,914
31-03-18	6,71,914	61,083	6,10,831
31-03-19	6,10,831	61,083	5,49,748
31-03-20	5,49,748	61,083	4,88,665

31-03-21	4,88,665	61,083	4,27,582
31-03-22	4,27,582	61,083	3,66,499
31-03-23	3,66,499	61,083	3,05,416
31-03-24	3,05,416	61,083	2,44,332
31-03-25	2,44,332	61,083	1,83,249
31-03-26	1,83,249	61,083	1,22,166
31-03-27	1,22,166	61,083	61,083
31-03-28	61,083	61,083	0

Calculation of lease liability:

Dates of payments	Lease rent outflow	PV Factor	Present value
01-04-19	-	-	-
01-04-20	1,25,000	0.8969	1,12,108
01-04-21	1,25,000	0.8044	1,00,545
01-04-22	1,25,000	0.7214	90,175
01-04-23	1,56,250	0.6470	1,01,093
01-04-24	1,56,250	0.5803	90,666
01-04-25	1,56,250	0.5204	81,315
01-04-26	1,56,250	0.4667	72,928
01-04-27	1,56,250	0.4186	65,407
			7,14,236

Unwinding of lease liability

Dates	Advance rental payments	Opening balance	Interest cost	Closing balance
01-04-19		7,14,236	82,137	7,96,374
01-04-20	125000	6,71,374	77,208	7,48,582
01-04-21	125000	6,23,582	71,712	6,95,293
01-04-22	125000	5,70,293	65,584	6,35,877

01-04-23	156250	4,79,627	55,157	5,34,784
01-04-24	156250	3,78,534	43,531	4,22,066
01-04-25	156250	2,65,816	30,569	2,96,385
01-04-26	156250	1,40,135	16,115	1,56,250
01-04-27	156250	-	-	-

Reconciliation of operating lease commitments to lease liabilities

Lease commitments as per Ind AS 17 as on 31 March 2019 (future lease rent of building + future lease rent of laptops) (12,81,250 + 30,00,000)	42,81,250
Less: Interest expenses	4,42,014
Less: Advance lease rent payment on 1 April 2019	1,25,000
Less: Exemption of low value lease on laptop (15000X4X50)	30,00,000
Lease liability as on 1 April 2019	7,14,236

Option 2: The entity does not avail the practical expedient of using hindsight to determine lease tenure.

Calculation of ROU

Dates	Cash outflow	PV Factor	Present value
01-04-18	1,25,000	1.0000	1,25,000
01-04-19	1,25,000	0.8969	1,12,108
01-04-20	1,25,000	0.8044	1,00,545
01-04-21	1,25,000	0.7214	90,175
01-04-22	1,25,000	0.6470	80,874
01-04-23	1,56,250	0.5803	90,666
01-04-24	1,56,250	0.5204	81,315
01-04-25	1,56,250	0.4667	72,928
01-04-26	1,56,250	0.4186	65,407
01-04-27	1,56,250	0.3754	58,661
		Total ROU	8,77,678

Amortisation of ROU:

Dates	Opening balance	Depreciation	Closing balance
31-03-19	8,77,678	87,768	7,89,911
31-03-20	7,89,911	87,768	7,02,143
31-03-21	7,02,143	87,768	6,14,375
31-03-22	6,14,375	87,768	5,26,607
31-03-23	5,26,607	87,768	4,38,839
31-03-24	4,38,839	87,768	3,51,071
31-03-25	3,51,071	87,768	2,63,304
31-03-26	2,63,304	87,768	1,75,536
31-03-27	1,75,536	87,768	87,768
31-03-28	87,768	87,768	-

Since the entity has applied modified retrospective approach for calculation of lease liability, its unwinding will be same as discussed above in option 1

Reconciliation of operating lease commitments to lease liabilities

Lease commitments as per Ind AS 17 as on 31 March 2019 (future lease rent of building + future lease rent of laptops) (12,81,250 + 30,00,000)	42,81,250
Less: Interest expenses	4,42,014
Less: Advance lease rent payment on 1 April 2019	1,25,000
Less: Exemption of low value lease on laptop (15000X4X50)	30,00,000
Lease liability as on 1 April 2019	7,14,236

Appendix I

Note: The purpose of this Appendix is only to bring out the major differences, if any, between Indian Accounting Standard (Ind AS) 116 and the corresponding International Financial Reporting Standard (IFRS) 16, Leases issued by the International Accounting Standards Board.

Major differences between Ind AS 116*, Leases and IFRS* 16, *Leases*

(i) With regard to subsequent measurement, 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 right-of-use assets that meet the definition of investment property. Since Ind AS 40, *Investment Property*, does not allow the use of fair value model, paragraph 34 has been deleted in Ind AS 116. Accordingly, reference to paragraph 34 has been deleted in paragraph 29. Paragraph C9(b) and paragraph C9(c) of Appendix C, *Effective Date and Transition*, given in context of fair value model of investment property have been deleted. However, paragraph numbers have been retained in Ind AS 116 to maintain consistency with paragraph numbers of IFRS 16.

(ii) Paragraph 50(b) of IFRS 16 requires to classify 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. However, Ind AS 7 requires interest paid to be treated as financing activity only. Accordingly, paragraph 50(b) has been modified in Ind AS 116 to specify that cash payments for interest portion of lease liability will be classified as financing activities applying Ind AS 7.

Appendix II

Note: The purpose of this Appendix is only to bring out the major differences, if any, between Indian Accounting Standard (Ind AS) 116, Leases and Accounting Standard (AS) 19, Leases

Major differences between Ind AS 116, *Leases and* AS 19, *Leases*

(i) *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.

(ii) *Modifications*: Ind AS 116 brings in comprehensive prescription on accounting of modifications in lease contracts.

(iii) *Scope:* AS 19 excludes leases of land from its scope. Ind AS 116 has no such scope exclusion.

(iv) Ind AS 116 makes a distinction between 'inception of lease' and 'commencement of lease' unlike AS 19.

(v) For lessor, the treatment of initial direct costs under Ind AS 116 differs from the treatment prescribed under AS 19. This is tabulated below:

Subject	***AS 19***	***Ind AS 116***
Finance lease-lessor accounting		
Non-manufacturer/ Non-dealer	Either recognised as expense immediately or allocated against the finance income over the lease term.	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable.
Manufacturer/dealer	Recognised as	Same as per AS 19.

	expense immediately.	
Operating lease- Lessor accounting	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.	Added to the carrying amount of the leased asset and recognised as expense over the lease term on the same basis as lease income.

(vi) Major difference in 'Lessee Accounting' are as follows:

Subject	***AS 19***	***Ind AS 116***
Classification	AS 19 requires a lessee to classify leases as either finance leases or operating leases.	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.
Operating lease accounting	Lease payments under an operating lease are recognised as an expense on a straight line basis over the lease term, unless another systematic basis if more appropriate. Operating leases are not reported	Under Ind AS 116, a lessee is required to recognise assets and liabilities for all leases unless it applies the recognition exemption i.e., Assets under lease (Right of use asset) and related liabilities will be recorded in the books of

	on a company's Balance sheet i.e. liabilities are treated as an off balance sheet expense.	account.
Treatment of Contingent rents and Variable lease payments	Under AS 19, all items considered as Contingent Rents were accounted in the period in which the event or condition that triggers those payments occurs.	The concept of Contingent Rent has been replaced with Variable Lease Payments. In Ind AS 116, such items are termed as variable lease payments and accounting for some items differs. Variable Lease Payments that depend on an index or a rate (e.g. Consumer Price Inflation index, Interest rate benchmark - MIBOR, are included in the initial measurement of lease liability using the index or rate as at the commencement date. Subsequent changes in those index or rate are adjusted as in the lease liability and right of use asset in the period in which those changes occur. Other Variable Lease Payments such as those linked to future sales are recognised in the statement of profit and Loss in the period in

		which the payment trigger occurs.

(vii) *Sale & Leaseback transactions:*

(a) 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. 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.

(b) 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.The Seller lessee shall measure right-of-use asset at the proportion of the previous carrying amount that relates to right-of-use retained by the seller-lessee. Hence, gain/loss is recognised only to the extent of rights transferred to the buyor-lessor and it will be different from the amount that would have been recognised under AS 19. 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.

(viii) Ind AS 116 contains clearer definition of 'initial direct costs'. Further, definition of the term 'interest rate implicit in the lease' has been modified in Ind AS 116.

(ix) *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 P&L, Statement of Cash flows.

(x) *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.