TOPIC

INDAS – 116
LEASES

Quote:

"The higher you go

the more challenges

you face.

Every new Levels

Attract new devils"

PART I – APPLICABILITY & SCOPE

APPLICABILITY:

On 30th March, 2019, Ministry of Corporate Affairs (MCA) has notified new standard on leases i.e Ind AS 116.

Ind AS 116 is fully converged with IFRS 16.

This new standard replaced the erstwhile Ind AS 17 and is effective from financial periods beginning on or after 1st April, 2019 i.e. first financial year is 2019-20

IndAS 116 brought following Major changes as compared to IndAS 17:

1. ***New definition of the lease*** can cause that some contracts previously treated as "service contracts" can now be treated as "lease contracts",
2. Accounting for leases ***in the lessee's financial statements*** changed and lessees do not classify the lease anymore. Instead, they should account for all the leases in the same way.

WHY INDAS 116 LEASES?

The main reason is that under IndAS 17, lessees were still able to hide certain liabilities resulting from leases and simply not present them on the face of the financial statements. Here we are talking about "Operating Leases"

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

Under the new standard, lessees will need to show all the leases right in their statement of financial position instead of hiding them in the notes to the financial statements.

Objective of IndAS 116 is to provide the following criteria for Leases:

a) Recognition
b) Measurement
c) Presentation
d) Disclosure

This ensures that both Lessee and Lessor provide relevant information that **faithfully represents those transactions.** So that users of financial statements can assess the effect of lease on Financial Position, Financial Performance and Cash Flows of the entity.

SCOPE OF INDAS 116:

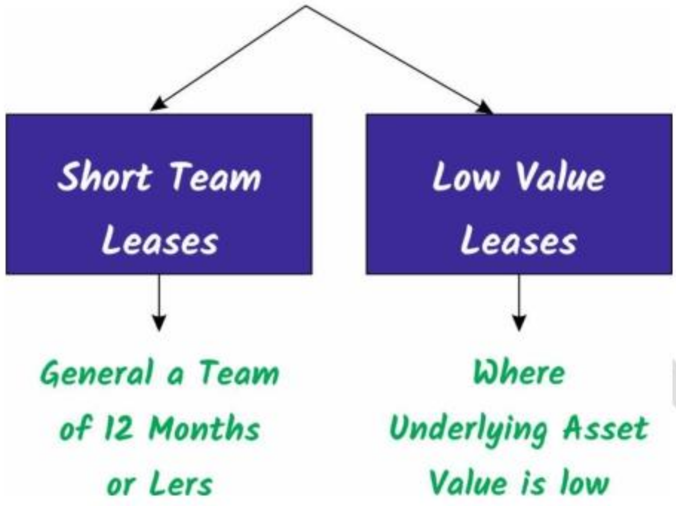
Ind AS 116 shall be applied to ALL LEASES, including leases of Right-of-Use (ROU) assets in a sub-lease, **EXCEPT** for:

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

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

FOLLOWING ARE LEASES BUT EXCEPT UNDER RECOGNITION NORMS OF INDAS 116:

*A lessee can elect not to apply Ind AS 116's **recognition** requirements to:*



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

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

(A) Short Term Leases

Meaning - *A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset.*

Conditions –

(a) *This Exemption shall be applied to the entire class of Underlying Assets on Which Lessee has Right to Use.*

(b) *Lessee has to make a policy to recognise the Lease Payments in relation to Short Term Leases (it may be SLM or any other systematic basis) and apply this policy for all the future Short Term Leases.*

Renewal Option – If the option of renewal of term (beyond 12 Months) is available at commencement date –

Such option is Reasonable Certain	Option is not Reasonable Certain
Not a Short Term Lease	Short Term Leases

(B) Leases of Low Value Assets (Low Value Leases):

Individual Asset having Low Value can be exempted from Recognition criteria of IndAS 116. However, IndAS 116 does not explicitly define the leases of low-value assets.
The exemption for leases of low—value items intends to capture leases that are high in volume but low in value — e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. Ind AS 116 is silent on any threshold to determine the value for classifying any asset as low value assets.

Individual Asset having Low Value can be Exempted from IndAS 116 only when following two conditions are satisfied-

(i) Such Asset can provide Benefit to Lessee on its own (i.e. it is capable of giving benefit individually) or Together with other resources which are readily available.
(ii) Such Asset is not highly dependent on highly interrelated with other Assets.

Examples of Low Value Leases

(a) Personal Computers
(b) Small Items of Office Furniture
(c) Tablets

When a New Asset is typically not of a Low Value then this exemption will not be applied, example Lease of Cars would not qualify because new car would typically not be of Low Value.

Sub-letting of Leased Asset - If a lessee sub-leases an asset, or expects to sub-lease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset.

PART 2 - IMPORTANT DEFINTIONS

(1) WHAT IS LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease. For the purpose, a lease is defined as –

- a contract, or part of a contract
- that conveys the **right to control** the use of an **identified asset**
- for a **period of time**
- in **exchange for consideration**.

(2) The ***Inception of The Lease*** is the earlier of –

- the date of the lease agreement and
- the date of commitment by the parties to the principal provisions of the lease.

(3) The ***Commencement of The Lease*** term is the date on which a lessor makes an underlying **asset available for use** by a lessee, i.e the date from which the lessee is entitled to exercise its right to use the leased asset.

Inception of the Lease	Commencement of the Lease
As at this date, the lessee shall **assess** if the contract is or contains lease.	As at this date- **Lessee** initially recognises a lease liability and related Right of Use Asset **Lessor** (for finance leases) initially recognises its net investment in the lease on the commencement date. In simple terms, Journal Entries are recorded from the Commencement date.

(4) RIGHT TO CONTROL

To assess whether lessee has 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 (lessee) has both of the following:

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

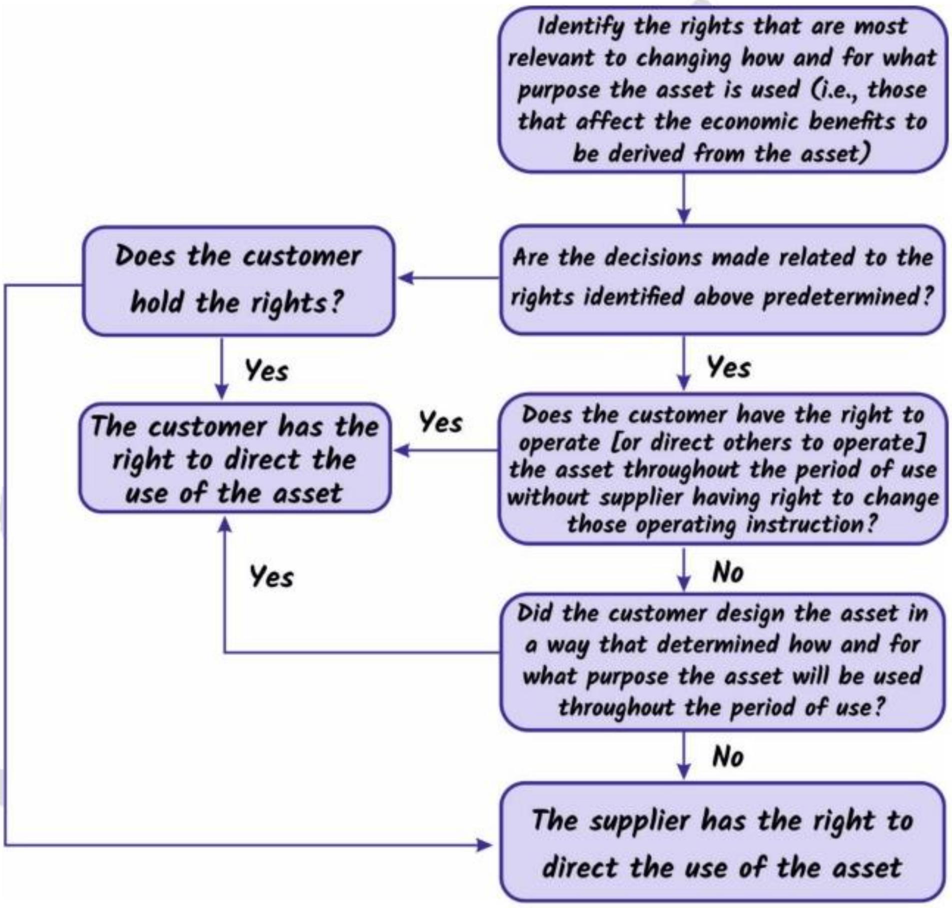
(b) *The* ***right to direct the use*** *of the identified asset, however it may no necessarily be documented.*

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

How to determine whether customer has Right to obtain substantially all of the Economic Benefits?	**How to determine Right to Direct the Use of the Identified Asset?**
(Having right to obtain substantially all the Economic Benefits means customer can exclusively use the asset throughout that period). A customer can obtain economic benefits either **directly** or **indirectly** (for e.g., by using, holding or subleasing the asset). Economic benefits from use of an asset include: • Producing/Manufacturing the Goods from the identified Asset for the purpose of Sale • Providing Services in the ordinary course of business from use of identified Asset thereby increasing the Turnover. • Subleasing the Asset to third party and realizing lease rent. If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (for e.g., if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration	A customer has the right to direct the use of an identified asset whenever it has the right to direct **how and for what purpose** the asset is used throughout the period of use (i.e., it can **change** how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a **SINGLE CONCEPT** (i.e., 'how' an asset is used is **not assessed separately** from 'for what purpose' an asset is used). The focus should be on whether the customer has the **decision-making rights that will most affect the economic benefits** that will be derived from the use of the asset.

for that use), that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.	

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



(5) IDENTIFIED ASSET

An arrangement only contains a lease if there is an **identified asset**. Under IndAS 116, an identified asset can be -

- explicitly specified in a contract or
- Implicitly specified at the time that the asset is made available for use by the customer.

Identified Asset **must be** physically distinct, be it entirely or in some portion.
For Example - A building is generally treated a physically distinct but one floor may also be considered as physically distinct if the same can be used independently.

Substantive Substitution Rights with Supplier

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

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

(a) Supplier has the **Practical ability** to substitute alternate asset **throughout the period of use**. (This means substituting the asset for reasons other than operational inefficiency or any contractual obligation.)

(b) The Supplier would **Benefit Economically** from substituting the asset. (For Ex: One high cost machinery with another similar low cost machine so that supplier can earn more from the high value machine by leasing it or selling it to third party).

However, 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**.

Substantive Rights must be checked only on the basis of facts and circumstances available at the inception of the lease and Future Events which are not likely to occur shall be ignored.

Supplier's right / obligation to substitute asset for repairs & maintenance in case asset doesn't work properly or for upgrade doesn't amount to substitution right as above.

Ind AS 116 further clarifies that without sufficient evidence, a customer should **presume** that a supplier's substitution right is **not substantive** if it is not possible to **readily determine** whether the supplier has a substantive substitution right.

(6) PERIOD

'A period of time' may be described in terms of the amount of use of an identified asset (**for e.g.**, the number of production units that an item of equipment will be used to produce). It includes any non-consecutive periods of time (for eg. 3 months in every year I will use the Vehicle to run my business).

(7) LEASE TERM

The Non-Cancellable period for which Lessee has the right to use an underlying asset. It includes –

(a) Renewal periods if it is reasonably certain to exercise; and

(b) Cancellable period (there is an option to terminate the lease) if it is reasonable that lessee does not exercise this option.

Note:

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.

Cancellable leases:

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

An arrangement is **not enforceable** if:

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

(ii) with no more than an insignificant penalty

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

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

PART 3 – RECOGNITION AND MEASUREMENT OF LEASE CONTRACT IN THE BOOKS OF LESSEE

Here we need to understand the recognition and measurement of following in the books of Lessee:

(a) RIGHT – OF – USE ASSET
(b) LEASE LIABILITY

INITIAL RECOGNITION AND MEASUREMENT

LEASE LIABILITY	RIGHT-OF-USE ASSET
Recognise at PV of remaining lease payments to be made over the lease term discounted using the Implicit Rate of Interest (i.e. IRR) If Implicit rate of interest can-not be readily determined then take Lessee's Incremental Borrowing Rate. **Lease Payments covers -** Amt. payable to a lessor in relation to Right to Use an underlying Asset. • Fixed Payments less Lease Incentives • In-substance Fixed Payments • Variable Lease Payments depends on Index or Rate • Guaranteed Residual Value • Purchase option price • Penalties for Terminating the Lease **Lease Payments Excludes –** • Payment made for and allocated to Non-lease Component (if accounted for separately) • Variable Lease Payments not dependent on Index or Rate	A lessee initially measures the ROU Asset at **COST.** Cost Comprise of following – • Initial Measurement of Lease Liability • Any Lease Payment made at or before the commencement date less incentives received. • Any initial direct costs incurred by the lessee • Initial estimated cost to be incurred by lessee in dismantling and removing the underlying asset.

Let's define each and every term in Lease Payments deeply-

Fixed Lease Payments	An amount agreed between lessee and Lessor
In Substance Fixed Payments	Payments which may contain variability but that in substance are unavoidable. These payments are variable as per the terms given in the agreement, but there is no genuine variability in those payments. **Example** – A Lessee enters into a 10 year lease of commercial space, for which lease payment will be Rs. 1000/- Per month unless sales are more than Rs. 20000. If sales will be higher than 20000/- the lease payment will be Rs. 1,00,000 pm, it is normal for a lessee to make a sale of at-least Rs. 5,00,000 pm.
Lease Incentives receivable from Lessor	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. upfront cash payment to the lessee payment of costs for the lessee (such as moving / transportation expenses)
Variable Lease Payments	Only those payments will be covered which are depending on Index or a Rate. Eg. Payments linked to consumer price index Payments linked to a Benchmark Interest Rate (such as Libor, PLR) Use Index or the Rate at the Commencement date while measuring Lease Payment. Payments which are not depending on Index or a Rate like based on Revenue of the entity or profits of entity, those payments will not be a part of Lease Payments and directly charged to Profit and Loss A/c if paid.
Purchase option price	If the lessee is **reasonably certain** to exercise a purchase option, the exercise price is **included** as a lease payment
Penalties for terminating a lease	If it is **reasonably certain** that the lessee will not terminate a lease, the lease term is determined assuming that the

	termination option would not be exercised, and any termination penalty is **excluded** from the lease payments. **Otherwise**, the lease termination penalty is **included** as a lease payment.
Guaranteed Residual Value (GRV)	It is the guarantee given on the residual value of the asset. At the end of lease term, the value of the leased asset must be of this amount. If the residual value of the asset is less than the guaranteed value; the lessee needs to pay the balance amount (GRV less Actual Residual Value)
Discounting Rate	1st Priority – Interest Rate Implicit in the Lease (i.e. IRR) of the Lessor 2nd Priority – Lessee's Incremental Borrowing Rate.
Interest Rate Implicit in the Lease (i.e. IRR)	It is the rate at which- • PV of Lease Payments + Unguaranteed Residual Value (UGRV of Lessor) is Equal to • Fair Value of the Underlying Asset + Initial Direct Cost
Lessee's Incremental Borrowing Rate	It is the rate at which Lessee can Borrow additional funds over a similar terms, security for the same amount of underlying asset.

Initial Direct Costs

'Initial direct costs' are defined as **the incremental costs of obtaining a lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

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

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

SUBSEQUENT MEASUREMENT

RIGHT-OF-USE ASSET	LEASE LIABILITY
At every BS date measure ROU Asset using COST Model (IndAS 16). Entity may also applied REVALUATION Model (IndAS 16) if it follows on All ROU Assets of same class. **Cost Model-** Initially measured ROU Asset Less – Accumulated Depreciation Less – Accumulated Impairment Loss Less – Change in Lease Liability (Re-Measurement) **Depreciation-** • Apply **IndAS 16** to depreciate ROU Asset • Period of Depreciation will be from the Commencement Date **to the end of Useful life** (if ownership will be transferred to lessee at the end of lease term or lessee has option to purchase the asset at the end of the term if reasonable certain. • Period of Depreciation will be from the Commencement Date **till Remaining useful life of the asset or Lease Term whichever is lower** if ownership is not getting transferred or no option to buy.	Lease Liability at the BS Date shall be measured similar to Financial Liability as per IndAS 109 (Amortised Cost basis) i.e. – • Increasing the carrying amount to reflect interest on the lease liability • Reducing the carrying amount to reflect the lease payments made; and • Re-measuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments. **(Changes in the future lease payments to be made)** **(Re-measurement is being separately discussed on the next page)**

WHAT ARE THE EXPENSES WHICH LESSEE SHALL TRANSFER TO ITS PROFIT AND LOSS STATEMENT?

Lessees recognise the following items in expense for leases:

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

RE-MEASUREMENT OF LEASE LIABILIITY

Causes of Re-Measurement	Which Discount Rate to Use?	Accounting Entry
Change in the Lease Term Determine the new lease payment based on new lease term and compute the lease liability	Revised Discount Rate	ROU Asset A/c Dr. To Lease Liability (Increase in LL)
Change in assessment of an option to purchase the asset (At the commencement, lessee thought of buying and subsequently due to market changes may change its mid set to Not Exercising the option or vice versa	Revised Discount Rate	Lease Liability A/c Dr To ROU Asset A/c (Decrease in LL) If Carrying amount of ROU Asset is Zero or reduced to Zero and if there is further reduction due to measurement then remaining difference to Profit and Loss A/c
Change in Expected GRV	Original Discount Rate	
Change in future lease payments due to change in an Index or a Rate	Original Discount Rate	

PART 4 – IMPORTANT POINTS

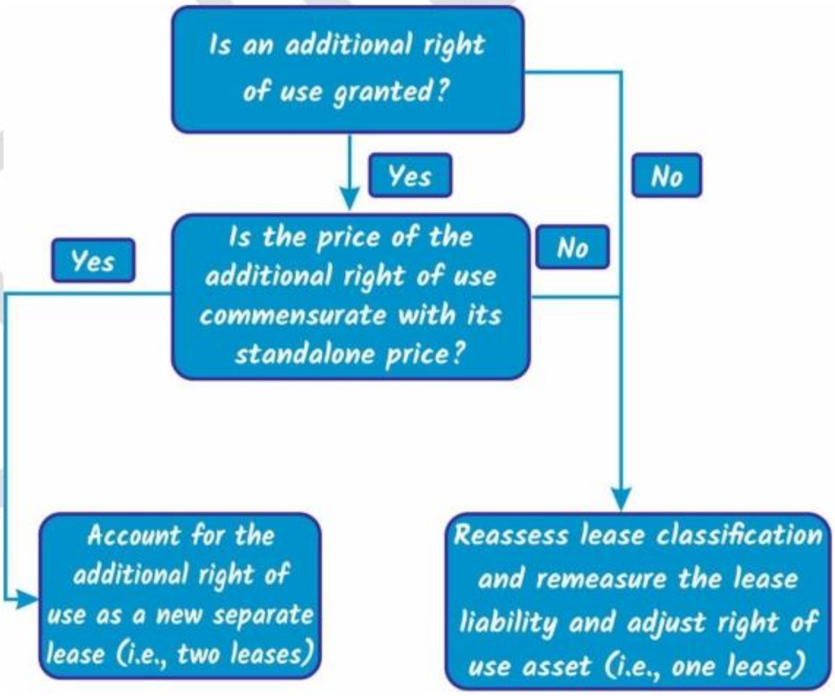
Lease of Multiple Assets: Contract that contains Right to Use Multiple Assets (2 or more Buildings, Building with equipments etc). Right to Use each Asset shall be treated as "Separate Lease Component" (i.e separate Contract) only when two conditions fulfilled	(a) Underlying asset provides benefit on 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. If any one or both the conditions are not met then, the right to use multiple assets is considered a Single Lease Component. **Example**
How to Separate lease components from non-lease components	Lease contract may contain an agreement to supply other goods or services. Such other goods or services may be non-lease component. Only items that contribute to securing the output of the asset are lease components. **Example 1** a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). This service is not related to securing the use of the truck. **Example 2** Payments for maintenance activities, including common area maintenance (for e.g., cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the lessee (for e.g., providing utilities or rubbish removal) are

	considered as **non-lease components** because they provide the lessee with a service.
Not a Separate Component of Contract	*Any payment made by lessee to lessor that relate to the Lease Asset and for those activities that do not transfer separate Goods or Services to the lessee.* *(for e.g., payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is)*
Optional exemption of using Practical Expedient to not to separate non-lease component	*Ind AS 116 provides a practical expedient that permits lessees to make an* ***accounting policy election****, by* ***CLASS OF UNDERLYING ASSET****, to account for each separate lease component of a contract and any associated non-lease components as a* ***SINGLE LEASE COMPONENT****. It is important to note the practical expedient is not permissible for lessor.*
How to allocate the total consideration to Lease and Non-lease Components	*On the basis of observable Stand-alone Prices of Lease and Non-lease Component.* *Stand-alone Prices means the Prices at which a customer would purchase a component of a contract separately when available.* *If observable stand-alone prices are not readily available, lessees* ***estimate*** *stand-alone prices, maximising the use of observable information.*
How to account Non-lease Component?	*As per the Other Applicable Standards*
CONTRACT COMBINATION *Two or More contracts with Same party entered into or near the same time be considered a "Single Contract" if any one of these criteria are met -*	*The contracts are negotiated as a package* *Or* *The amount of the consideration to be paid in one contract depends on the price or performance of the other contract.* *Or*

	All or some Rights to use the assets in lease as are prescribed in the contract are a single lease component. ***Let us take an example:*** *Separate contracts entered into between lessee and lessor to lease factory & Building, Machineries, and Vehicles. The common overall objective is to run a factory for a commercial production purpose. In such case individual contract to lease a land & Building or Machineries or Vehicles would not help to understand the single overall objective. Further since the objective is common hence price and performance of these assets are interrelated.*

LEASE MODIFICATIONS

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



PRESENTATION IN FINANCIAL STATEMENTS

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

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

PART 5 – RECOGNITION AND MEASUREMENT OF LEASE CONTRACT IN THE BOOKS OF LESSOR

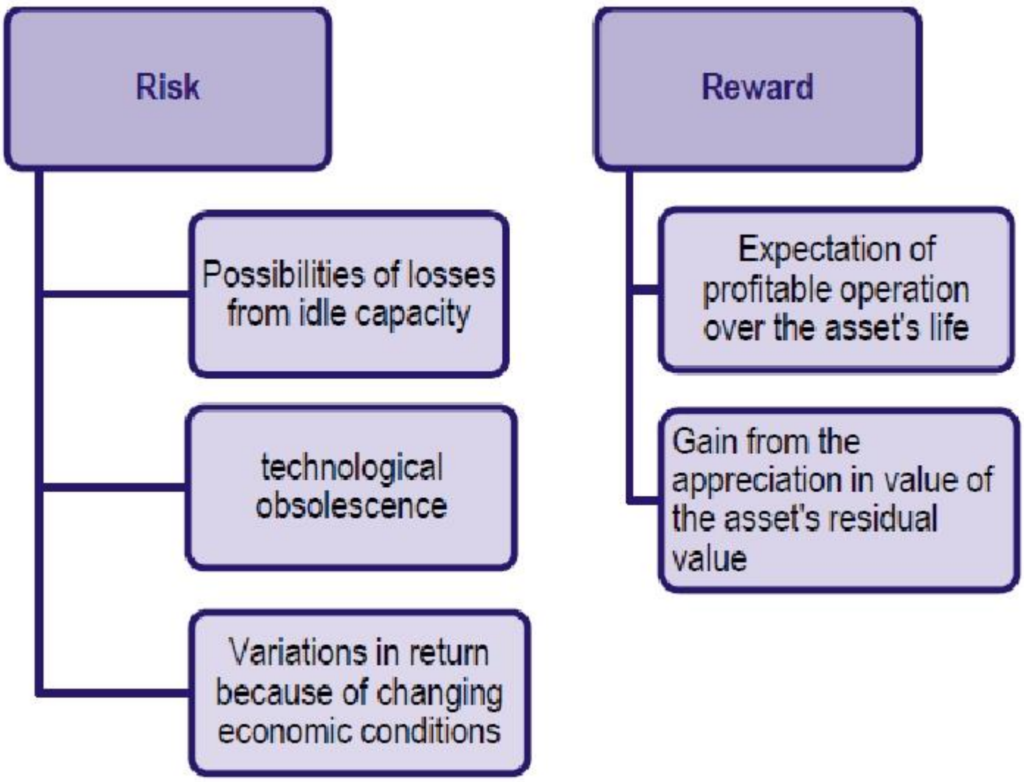
A **'lessor'** is defined as an entity that provides the right to use an ***underlying asset*** for a period of time in exchange for consideration.

At inception, lessors classify all leases as FINANCE LEASE or OPERATING LEASE. Lease classification is very important because it determines how and when a lessor recognises lease income and what assets are recorded.

Types of Leases

There are 2 types of leases defined in INDAS 17:

1. ***An Operating Lease*** is a lease other than a finance lease.
2. ***A Finance Lease*** is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Legal title may or may not eventually be transferred.



FINANCE LEASE

Situations and Indicators of Finance Lease

INDAS 116 outlines examples of ***situations*** that would normally lead to a lease being classified as ***a finance lease***:

- The ***lease transfers ownership*** of the asset to the lessee by the end of the lease term.
- The lessee ***has the option to purchase the asset at a price*** that is expected to be ***sufficiently lower*** than the fair value at the date of the option exercisability. It is reasonably certain, at the inception of the lease, that the option will be exercised.
- The ***lease term is for the major part of the economic life*** of the asset even if the title is not transferred.
- At the inception of the lease the present value of the **minimum lease payments** amounts to at least substantially all of the fair value of the leased asset.
- The leased assets are of such a **specialized nature** that only the lessee can use them without major modifications.

KEY CONCEPTS FOR UNDERSTANDING LESSORS ACCOUNTING

'Gross investment in the lease' is the **SUM** of: (GIL)	(a) the lease payments receivable by a lessor under a finance lease; **AND** (b) any unguaranteed residual value accruing to the lessor.
'Net investment in the lease' (NIL)	is the gross investment in the lease discounted at the interest rate implicit in the lease. (PV of GIL) NIL = PV of Lease Payments + UGRV – Initial Direct Cost
'Unguaranteed residual value' **(Total Estimated Residual Value less GRV)**	is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial Recognition

At the commencement of the lease term, lessor should recognize **Lease Receivable** in his statement of financial position. The amount of the receivable should be **equal to net investment in the lease.**

Net investment in the lease equals to gross investment in the lease (minimum lease payments receivable by the lessor under the finance lease + any unguaranteed residual value accruing to the lessor) discounted by **the interest rate implicit in the lease.**

The accounting entry is to debit Lease Receivable at Net Investment in Lease and credit Property, plant and equipment at Carrying Amount and transfer difference to Profit and Loss Statement.

Subsequent Measurement

The lessor should split minimum payments received into finance income and reduction of the lease receivable. **Finance income** shall be recognized based on a pattern reflecting constant periodic rate of return on the lessor's net investment in the lease.

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

The accounting entry is as follows:

DEBIT: Cash /	CREDIT: Finance Income (Interest)
	CREDIT: Lease Receivable

At every BS date, Lease Receivable shall be recognised at Current Net Investment in Lease (i.e. PV of Remaining Lease Payments + Re-estimated UGRV).

UGRV shall be reviewed at-least once in a year and if there is **any reduction** in the estimated UGRV the reduced amount shall be taken into account, this will result in reduction of Finance Income of the lessor.

Manufacturers or Dealer Lessor

Manufacture or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.

Initial direct costs are excluded from the net investment in the lease and are recognised as an expense when the selling profit is recognised, which for a finance lease is normally at the commencement of the lease term. Manufacture or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacture or dealer lessor gives rise to two types of income:

a) *Profit or loss equivalent to profit or loss resulting from an outright sale of the asset being leased, at normal selling price; and*
b) *Finance income over the lease term.*

Sale Revenue -

The sales revenue recognised at the commencement of the lease term by a manufacturer or dealer lessor **is the fair value of the asset, or, if lower, the present value of the minimum lease payments accruing to the lessor***, computed at a market rate of interest.*

Journal Entry would be:

Lease Receivable A/c	Dr. Net Investment in Lease
To Sales A/c	Fair value or PV of Lease P (whichever is lower)
To Profit on Sales	(Balancing figure)

Initial Direct Cost incurred by Manufacturer or Dealar:

Costs incurred by manufacturers or dealer lessor in negotiating and arranging the lease shall be recognized as an expense when selling profit is recognized.

OPERATING LEASE

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

Variable lease payments that do not depend on an Index or a Rate are excluded in the above treatment and are instead recognised as income when they arise.

Initial Direct Costs – Brokerage, Legal Charges etc, are incurred only because of the lease i.e. these would have not been incurred if the lease does not exist.
Ind AS 116 also requires lessors of operating leases to **defer** initial direct costs at lease commencement and recognise them over the lease term on the **same basis** as lease income if the initial direct costs amount are material otherwise immediately charged to Profit and Loss statement.

LEASE OF LAND AND BUILDING

- When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with the general criteria discussed in this standard. In determining whether the land element is an operating or a finance lease, an important consideration is that **land normally has an indefinite economic life**.

- Whenever necessary in order to classify and account for a lease of land and buildings, **the Lease Payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values** of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.

- If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

- For a lease of land and buildings under which the present value of the Lease Payments allocated to the land at the inception of the lease is **immaterial**, the **land and buildings may be treated as a single unit for the purpose of lease classification** and classified as a finance or operating lease in accordance with the general criteria discussed in this standard. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

LEASE MODIFICATIONS

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

(1) Finance Lease Modification

Modification- Separate lease:

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

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

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

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

Modification- Not Separate lease:

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

The lease would have been classified as operation with the modification at the inception date	• **Account for the lease modification as a new lease from the effective date of the modification ; &** • **Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.**
All other lease modification	• **Apply the requirements of Ind AS 109 Financial Instruments.**

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

(2) Operating Lease Modification:

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

(3) Presentation

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

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

PART 6 = SUB – LEASES

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

Original Lease is Called – **Head Lease**
Original Lessee who has given the asset on sub-lease is called – **Intermediate Lessor**

Example – There are two lease agreements

1. Mr. Vishal has given an Asset on Lease to Mr. Darshan **(this is Head Lease)**
   Mr. Vishal is Lessor and Mr. Darshan is Lessee

2. Mr. Darshan sub-leased the same asset to Mr. Vijay **(Sub-Lease)**
   Mr. Darshan is intermediate lessor and Mr. Vijaj is Lessee)

Here we need to understand the Accounting in the books of Mr. Darshan (i.e. Original Lessee or Intermediate Lessor).

Accounting of Sub-lease in the books of Intermediate Lessor depends on the nature of Head Lease –

1. When the head lease is a **short-term** lease, the **sublease is classified as an operating lease**, this is because the Intermediate lessor has not recognised any ROU Asset and Lease Liability in its books under Head Lease. Therefore intermediate can never show the sub-lease as Finance Lease
2. When the head lease has been recognised by intermediate lessee in its books as ROU Asset and Lease Liability then treat the sub-lease as follows:

If the sublease is classified as a 'Finance Lease'	If the sublease is classified as an 'Operating Lease'
The original lessee de-recognises the ROU Asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the	The original lessee continues to account for the lease liability and ROU asset on the head lease like any other lease. If the total remaining carrying amount of

lessee accounting model. *The original lessee (as the intermediate lessor) recognises a net investment in the sublease and evaluates it for impairment.*	*the ROU asset on the head lease exceeds the anticipated sublease income, this may indicate that the ROU asset associated with the head lease is impaired (which is assessed for impairment under Ind AS 36).*

Note:

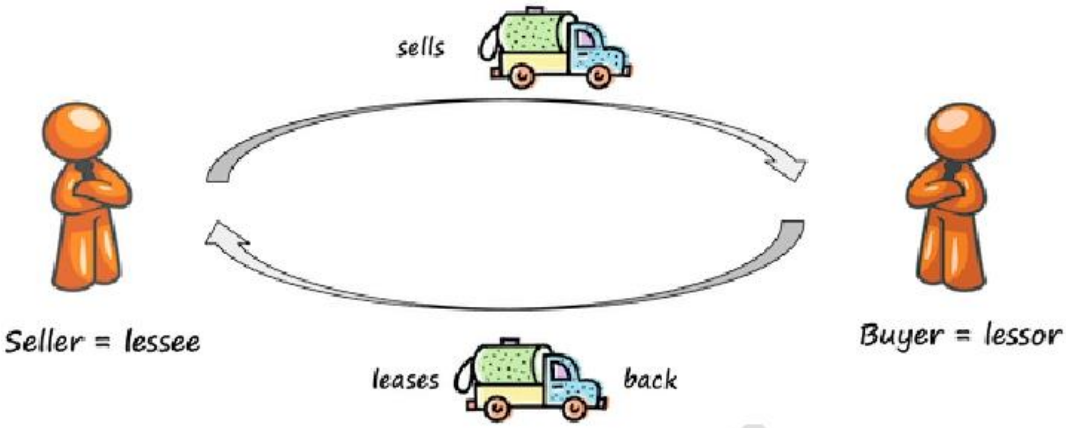
An intermediate lessor who subleases, or expects to sublease an asset, ***CANNOT*** *account for the head lease as a lease of a low-value asset* ***even when*** *the required criteria w.r.t. 'leases of low-value assets' (as discussed earlier) are satisfied.*

Presentation in the Financial Statements

- *Intermediate lessors are* ***not permitted*** *to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively.*
- *Similarly, intermediate lessors are* ***not permitted*** *to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively.*

PART 7 – SALE & LEASE BACK

A ***sale and leaseback transaction*** *involves the sale of an asset and the leasing the same asset back. In this situation, a seller becomes a lessee and a buyer becomes a lessor.*



SALES AND LEASE BACK involves two transactions-

1. *Sale of Asset by Seller Lessee to Buyer Lessor.*
2. *Lease Transaction*

Purpose of Sale and Lease Back Transaction:

Generally the sale and lease back transaction is occurred to arrange finance to the lessee (seller). Seller wants funds to apply in its business hence seller entity first sells the Asset to get the funds and then make a lease agreement with buyer for the same Asset so that it can continuously use the Asset also in its business.

I. Lease Back Transaction:

We have already understood the accounting treatment of lease transaction but for the sake of convenience let's understand it again in short:

a. *Seller lessee shall recognise ROU Asset and a Lease Liability (Financial Liability) at PV of Lease Payments (already defined) at Implicit Rate of Interest.*
b. *Here the lease liability is a sort of Financial Liability since seller lesser got the funds and Assets back.*

2. Sale Transactions (Very Important to Understand):

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

As per INDAS 115, sale and purchase can be recognised only when an entity satisfied a Performance Obligation by transferring **CONTROL** of an Asset. Thus, there are following two possibilities in this scenario:

If Control is passed	If Control is NOT passed
If the control of an underlying asset is **passed** to the buyer-lessor, the transaction is accounted for as a **'sale or purchase'** of the asset and a **'lease'**.	If the control of an underlying asset is **NOT passed** to the buyer-lessor, both the seller-lessee and the buyer-lessor account for the transaction as a **'financing transaction'**. Therefore IndAS 109 will be applied instead of IndAS 116.

(a) Transactions in which the transfer of an asset is a 'SALE':

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:

Seller-lessee	Buyer-lessor
The seller-lessee shall measure the ROU asset arising from the leaseback at the proportion of the previous carrying amount of the asset **that relates to the right of use retained by the seller-lessee**. $$\text{ROU Asset} = \frac{\text{CA} \times \text{Pv of LP}}{\text{FV of Asset}}$$ Accordingly, the seller-lessee shall recognise only the amount of any **gain or loss that relates to the rights transferred to the buyer-lessor**.	The buyer-lessor shall account for the purchase of the asset, applying applicable Ind ASs and for the lease, applying the lessor accounting requirements under Ind AS 116. Thus, a buyer-lessor accounts for the purchase of the asset in accordance with other Ind ASs based on the nature of the asset (for e.g., Ind AS 16 for property, plant and equipment).

Gain/Loss = $\frac{\text{Total Gain x PV of LP}}{\text{Fair Value of Asset}}$ **Total Gain Means = FV – CA Thus, the seller-lessee will: - **Derecognise** the underlying asset at Carrying Amount - **Recognise** the ROU Asset at above Proportionate Value. - **Recognise** the Lease Liability (Financial Liability) at PV of LP including any additional financing. - **Recognise** the gain or loss, if any, that relates to the rights transferred to the buyer-lessor (adjusted for off- market terms) **Journal Entry-** Cash/Bank A/c Dr. ROU Asset A/c Dr. To PPE A/c (Carrying Amt.) To Gain on transfer of Right A/c To Fin. Liab. A/c (PV of LP + Add.Loan)	

Sometimes, it is possible that the Sale transaction is not entered at Fair Value. Sale Value mahy be less or More than Fair Value OR the Lease Payments are not at Market Interest Rates. There may be following two possible scenarios:

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

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

<table>
<tr><th>When sale price or Present Value is LESS</th><th>When sale price or Present Value is GREATER</th></tr>
<tr><td>When the sale price is LESS than the underlying asset's fair value
OR
the present value of the lease payments is LESS than the present value of the market lease payments.

Either we got lower value on sale or will pay higher amount thru lease payments – also called Lease Prepayments

A seller-lessee recognises the difference as an increase to the sales price and the initial measurement of the ROU asset as a 'lease prepayment'.
In Simple terms, ROU Asset shall be increased by the difference Amount.</td><td>When the sale price is GREATER than the underlying asset's fair value
OR
The present value of the lease payments is GREATER than the present value of the market lease payments,

Either we got higher amount on sale or will pay lower amount thru lease payments – also known as Additional Financing.

A seller-lessee recognises the difference as a reduction in the sales price and an 'additional financing received' from the buyer-lessor.</td></tr>
<tr><td></td><td>Here the total annual consideration (Lease Payment) to be payable by lessee and receivable by lessor shall be bifurcated into two parts –
1. Real Lease Payments pa
2. Repayment of Excess funding by buyer lessor (difference amt.)

Real Lease payments =
$$\frac{\text{Total PV of LP} - \text{Additional Funding}}{\text{PVAF @ IRI}}$$</td></tr>
</table>

(b) Transactions in which the transfer of an asset is 'NOT a SALE':

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, do not apply IndAS 116 leases but apply IndAS 109:

Seller-lessee	Buyer-lessor
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. Thus, the seller-lessee accounts for the transaction as a **financing transaction**. The seller-lessee keeps the transferred asset subject to the sale and leaseback transaction on its balance sheet and accounts for amounts received as a **financial liability** in accordance with Ind AS 109. The seller-lessee decreases the financial liability by the payments made less the portion considered as interest expense.	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. Thus, the buyer-lessor does **not recognise** the transferred asset and accounts for the amounts paid as a **receivable** in accordance with Ind AS 109.

PART 8 – TRANSITION APPROACH

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

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

For Example – If entity applies IndAS wef FY 19-20, the Transition date means date of initial application and it will be 01.04.2019.

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

Transition Options for Lessors – apart from one specific exception in respect of sub-lease, no adjustments are required on transition from IndAS 17 to IndAS 116 because lessor accounting under IndAS 116 is largely consistent with the requirements of IndAS 17.

Transition Options for Lessees – For Lessee, situation is more complex since under IndAS 17 Lessee may have applied lease contract either as Operating Lease or Finance Lease and now both of these approaches are not available under IndAS 116. Instead IndAS 116 requires the lessee to recognise ROU Asset and Lease Liability at PV of Lease Payments.

Now for transition to IndAS 116, Lessees have two options:-

1. **Apply Full Retrospective Approach**
2. **Apply Modified Retrospective Approach**

Let's discuss the Transition treatment in the books of Lessees:-

Full Retrospective Approach
Retrospectively to each prior reporting period presented, applying IndAS 8, i.e., an entity applies IndAS 116 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If IndAS 116 is applied at 01 April 2019, this means that, in the 31 March 2020 financial statements, the comparative period to 31 March 2019 must be restated

(assuming that this is the only comparative period presented).

A restated opening balance sheet at 01 April 2018 will also need to be disclosed as required by IndAS 1.

Hence, the Balance Sheets for 3 different dates will be presented:
As at 31 March 2020, 31 March 2019 & 1 April 2018.

In simple words,

- Apply IndAS 116 to all Lease contracts appearing on Transition Date i.e. 01.04.2018 **in such a way that IndAS 116 would have been applied from the very inception of the lease.**
- Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date using the incremental borrowing rate **at lease commencement date.**
- Transfer the **difference** if any arising on application of transition provision to **Retained Earnings as on 01.04.2018.**
- The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation over the lease term. **The amount of O/s Lease Liability and Carrying amount of ROU Asset as on Transition date** will be shown in the Balance Sheet as on Transition date i.e. 01.04.2018 with difference in Retained Earnings.

Modified Retrospective Approach	
Leases Previously Classified as Operating Leases	**Leases Previously Classified as Finance Leases**
• Do not restate the comparative figures. • Recognise the cumulative effect of the IndAS 116 as on Initial Application date i.e. 01.04.2019 or any other later application date. • Recognise Lease Liability at PV of Remaining Lease Payments, discounted using the lessee's incremental borrowing rate at the date of initial application.	• The carrying amount of the ROU asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying Ind AS 17. • For such leases, a lessee shall account for the ROU asset and the lease liability applying Ind AS 116 from the date of

• *Recognise ROU Asset on a lease by lease basis at either –* **(a) Alternative 1** *– Its carrying amount as if IndAS 116 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application* ***OR*** **(b) Alternative 2 –** *An amount equal to the lease liability which is recognised at Initial application date.* • *Under Alternative 1, the difference between the Lease Liability Amount and ROU Asset Amount shall be transferred to Opening retained earnings.*	*initial application i.e. 01.04.2019 or any later date from which IndAS 116 is applied.* • *Thus, a lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of IndAS 116.*

Student Notes:-

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