

**(ii) Measurement basis for valuation of PPE:**

An entity has the following options with respect to measurement of its property, plant and equipment (Ind AS 16) in the opening Ind AS Balance Sheet:

- Measurement basis as per the respective standards applied retrospectively. This measurement option can be applied on an item-by-item basis. For example, Plant A can be measured applying Ind AS 16 retrospectively and Plant B can be measured applying the fair value or revaluation options mentioned below.
- Fair value at the date of transition to Ind AS. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.
- Previous GAAP revaluation, if such revaluation was, at the date of revaluation, broadly comparable to (a) fair value or (b) cost or depreciated cost in accordance with other Ind AS adjusted to reflect changes in general or specific price index. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.

**Analysis of given case:**

	Asset 1	Asset 2	Asset 3	Asset 4
Basis used in previous GAAP	Revaluation Model	Revaluation Model	Cost Model	Cost Model
Intent of G Ltd. on transition	To continue with Revaluation model	Use previous valuation as deemed cost	Adopt a policy of revaluation	Continue to use a policy of cost less depreciation
Treatment at the time of transition to Ind AS	Since fair value at the transition date is not materially different from its carrying value under previous GAAP, G Ltd. Can carry Forward with revalued carrying value ₹ 4,000 as per previous GAAP in Ind AS books and continue to disclose a revaluation surplus of ₹ 2,500.	An entity may elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date. In Ind AS financial statements, asset will be carried forward at ₹ 1,500 and previously disclosed revaluation surplus is transferred to retained earnings or another component of equity.	Fair value at the date of transition to Ind AS is materially different from its carrying value under previous GAAP. The asset should be revalued and stated at its fair value of ₹ 5,000 on the date of transition to Ind AS. A revaluation surplus of ₹ 3,000 (5,000 – 2,000) will be transferred to revaluation reserve.	The entity is not availing any exemption given in Ind AS 101. The entity can measure applying Ind AS 16 retrospectively. It is assumed that measurement bases for cost of asset as per previous GAAP and Ind AS are same so asset will be shown in the Ind AS financial statements at ₹ 2,800.

**IndAS 101 First Time Adoption Related SM Questions**

**SM 21.** X Ltd. was using cost model for its property, plant and equipment (tangible fixed assets) till March 31, 20X1 under previous GAAP. On April 1, 20X0, i.e., the date of its transition to Ind AS, it used fair values as the deemed cost in respect of its fixed assets. Whether it will amount to a change in accounting policy?

**Ans.**



Use of fair values on the date of transition will not tantamount to a change in accounting policy. The fair values of the property, plant and equipment on the date on transition will be considered as deemed cost without this being considered as a change in accounting policy.


**SM 22.** X Ltd. is the holding company of Y Ltd. X Ltd. is required to adopt Ind AS from April 1, 2016. X Ltd. wants to avail the optional exemption of using the previous GAAP carrying values in respect of its property, plant and equipment whereas Y Ltd. wants to use fair value of its property, plant and equipment as its deemed cost on the date of transition. Examine whether X Ltd. can do so for its consolidated financial statements. Also, examine whether different entities in a group can use different basis for arriving at deemed cost for property, plant and equipment in their respective standalone financial statements



**Ans.**


First- time adopter to Ind AS may elect to continue with the carrying value of all of its property, plant and equipment as at the date of transition measured as per the previous GAAP and use that as its deemed cost at the date of transition after making necessary adjustments. If a first time adopter chooses this option then the option of applying this on selective basis to some of the items of property, plant and equipment and using fair value for others is not available.

**Nothing prevents different entities within a group to choose different basis for arriving at deemed cost for the standalone financial statements. However, in Consolidated Financial Statements, the entire group should be treated as one reporting entity. Accordingly, it will not be permissible to use different basis for arriving at the deemed cost of property, plant and equipment on the date of transition by different entities of the group for the purpose of preparing Consolidated Financial Statements.**

**SM 23.**  Is it possible for an entity to allocate cost as per the previous GAAP to a component based on its fair value on the date of transition even when it does not have the component-wise historical cost?

**Ans.**

Yes, an entity can allocate cost to a component based on its fair value on the date of transition. This is permissible even when the entity does not have component-wise historical cost.

**SM 24.**  Revaluation under previous GAAP can be considered as deemed cost if the revaluation was, at the date of the revaluation, broadly comparable to fair value or cost or depreciated cost of assets in accordance with Ind AS, adjusted to reflect, e.g., changes in a general or specific price index. What is the acceptable time gap of such revaluation from the date of transition? Can adjustments be made to take effects of events subsequent to revaluation?

**Ans.**

There are no specific guidelines in Ind AS 101 to indicate the acceptable time gap of such revaluation from the date of transition. The management of an entity needs to exercise judgement in this regard. However, generally, a period of 2-3 years may be treated as an acceptable time gap of such revaluation from the date of transition. In any case, adjustments should be made to reflect the effect of material events subsequent to revaluation.

**SM 25.** For the purpose of deemed cost on the date of transition, an entity has the option of using the carrying value as the deemed cost. In this context, suggest which carrying value is to be considered as deemed cost: original cost or net book value? Also examine whether this would have any impact on future depreciation charge?

**Ans.**



For the purpose of deemed cost on the date of transition, if an entity uses the carrying value as the deemed cost, then it should consider the net book value on the date of transition as the deemed cost and not the original cost because carrying value here means net book value. The future depreciation charge will be based on the net book value and the remaining useful life on the date of transition. Further, as per the requirements of Ind AS 16, the depreciation method, residual value and useful life need to be reviewed atleast annually. As a result of this, the depreciation charge may or may not be the same as the depreciation charge under the previous GAAP.

**SM 26.**



X Ltd. was using cost model for its property, plant and equipment till March 31, 20X2 under previous GAAP. The Ind AS become applicable to the company for financial year beginning April 1, 20X2. On April 1, 20X1, i.e., the date of its transition to Ind AS, it used fair value as the deemed cost in respect of its property, plant and equipment. X Ltd. wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements. Whether use of fair values as deemed cost on the date of transition and use of revaluation model in the first annual Ind AS financial statements would amount to a change in accounting policy?

**Ans.**

In the instant case, X Ltd. is using revaluation model for property, plant and equipment for the first annual Ind AS financial statements and using fair value of property, plant and equipment on the date of the transition, as deemed cost. Since the entity is using fair value at the transition date as well as in the first Ind AS financial statements, there is no change in accounting policy and mere use of the term 'deemed cost' would not mean that there is a change in accounting policy.

**RT 27.**



An entity has the following items of property, plant and equipment:

- Property A — a vacant plot of land on which it intends to construct its new administration headquarters;
- Property B — a plot of land that it operates as a landfill site;
- Property C — a plot of land on which its existing administration headquarters are built;
- Property D — a plot of land on which its direct sales office is built;
- Properties E1–E10 — ten separate retail outlets and the land on which they are built;
- Equipment A — computer systems at its headquarters and direct sales office that are integrated with the point of sale computer systems in the retail outlets;
- Equipment B — point of sale computer systems in each of its retail outlets;
- Furniture and fittings in its administrative headquarters and its sales office;
- Shop fixtures and fittings in its retail outlets.

How many classes of property, plant and equipment must the entity disclose

**[SM, May-2021]**

**Ans.**

To answer this question one must make a materiality judgement.

A class of assets is defined as a grouping of assets of a similar nature and use in an entity's operations. The nature of land without a building is different to the nature of land with a building.

Consequently, land without a building is a separate class of asset from land and buildings. Furthermore, the nature and use of land operated as a landfill site is different from vacant land. Hence, the entity should disclose Property A separately. The entity must apply judgement to determine whether the entity's retail outlets are sufficiently different in nature and use from its office buildings, and thus constitute a separate class of land and buildings.

The computer equipment is integrated across the organisation and would probably be classified as a single separate class of asset.

Furniture and fittings used for administrative purposes could be sufficiently different to shop fixtures and fittings in retail outlets. Hence, they should be classified in two separate classes of assets.

## ADDITIONAL PRACTICE QUESTIONS

### Cost

**SM 28.**

**COST : BASIC**



On 1st April, 20X1, XYZ Ltd. acquired a machine under the following terms:

	₹
List price of machine	80,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	4,00,000
Purchase of a five-year maintenance contract with vendor	7,00,000

In addition to the above information XYZ Ltd. was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5%, if payment for the machine was received within one month of purchase. XYZ Ltd. paid for the plant on 20th April, 20X1. At what cost the asset will be recognised?

**Ans.**

In accordance with Ind AS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalised. Therefore, the initial purchase price of the asset should be:

	₹
List price	80,00,000
Less: Trade discount (10%)	<u>(8,00,000)</u>
	72,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	<u>4,00,000</u>
Total amount to be capitalised at 1st April, 20X1	<u>92,00,000</u>

Maintenance contract is a separate contract to get service, therefore, the maintenance contract cost of ₹ 7,00,000 should be taken as a prepaid expense and charged to the profit or loss over a period of 5 years. In addition the settlement discount received of ₹ 3,60,000 (₹ 72,00,000 x 5%) is to be shown as other income in the profit or loss.

**AD 29.**

**COST : NORMAL COSTS**



An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part of that gas will only be used to keep the cave under pressure in order to be able to get gas out of the cave. It is not possible to distinguish the gas that will be used to keep the cave under pressure and the rest of the gas.

Evaluate whether Ind AS 16 would apply or Ind AS 2?

**Ans.**

The total volume of gas must be virtually split into

- (i) Gas held for sale, and
- (ii) Gas held to keep the cave under pressure.

The former must be accounted for under Ind AS 2 as Inventories. The latter must be accounted for as PPE under Ind AS 16 and depreciated over the period the cave is expected to be used.

## DRS Costs

### SM 30. DRS COSTS : REESTIMATION



An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 2XX1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000 which included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31st March. On March, 2X11, the net present value of the decommissioning liability has decreased by ₹ 8,000. The discount rate has not yet changed.

How the entity will account for the above changes in decommissioning liability in the year 2X11, if it adopts cost model?

**Ans.**

On 31st March, 2X11, the plant is 10 years old. Accumulated depreciation is ₹ 30,000 (₹ 120,000 x 10 / 40 years). Due to unwinding of discount @ 5% over the 10 years, the amount of decommissioning liability has increased from ₹ 10,000 to ₹ 16,300 (approx.).

On 31st March, 2X11, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the decommissioning liability has decreased by ₹ 8,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 16,300 to ₹ 8,300. On this date, the entity passes the following journal entry to reflect the change:

	Dr.	₹		₹
Provision for decommissioning liability	Dr.	8,000		
To Asset			8,000	

Following this adjustment, the carrying amount of the asset is ₹ 82,000 (₹ 1,20,000 – ₹ 8,000 – ₹ 30,000), which will be depreciated over the remaining 30 years of the asset's life giving a depreciation expense for the next year of ₹ 2,733 (₹ 82,000 / 30). The next year's finance cost for unwinding of discount will be ₹ 415 (₹ 8,300 × 5 per cent).

## Recognition

### CE 31.



#### RECOGNITION: ROAD

Company X has incurred expenditure on construction of a road on the land which is not owned by the Company. Whether the expenditure incurred on construction of such a road by the Company has to be capitalised or expensed out under Ind AS?

**Ans.**

The capitalisation of expenditure incurred on construction of assets on land not owned by a company would depend on facts and circumstances of each case, particularly, considering paragraph 16(b) of Ind AS 16, Property, Plant and Equipment (PPE), which states that such an expenditure should be necessary for making the item of PPE capable of operating in the manner intended by the management.

### RT 32.

#### RECOGNITION: ROAD



ABC Ltd is setting up a new refinery outside the city limits. In order to facilitate the construction of the refinery and its operations, ABC Ltd. is required to incur expenditure on the construction/development of railway siding, road and bridge. Though ABC Ltd. incurs (or contributes to) the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Whether ABC Ltd. can capitalise expenditure incurred on these items as property, plant and equipment (PPE)? If yes, how should these items be depreciated and presented in the financial statements of ABC Ltd. as per Ind AS?

**[Nov-2018]**

Ans.

Paragraph 7 of Ind AS 16 states that the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- (a) it is probable that future economic benefits associated with the item will flow to the entity; and
- (b) the cost of the item can be measured reliably.

Further, paragraph 9 provides that the standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances.

Paragraph 16, inter alia, states that the cost of an item of property, plant and equipment comprise any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, railway siding, road and bridge are required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalisation of the said expenditure even though the company cannot restrict the access of others for using the assets individually. It is apparent that the aforesaid expenditure is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of this, even though ABC Ltd. may not be able to recognize expenditure incurred on these assets as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalised as a part of overall cost of the project. From this, it can be concluded that, in the extant case the expenditure incurred on these assets, i.e., railway siding, road and bridge, should be considered as the cost of constructing the refinery and accordingly, expenditure incurred on these items should be allocated and capitalised as part of the items of property, plant and equipment of the refinery.

### Depreciation

As per paragraph 43 and 47 of Ind AS 16, if these assets have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate, it should be depreciated separately. However, if these assets have a useful life and the depreciation method that are the same as the useful life and the depreciation method of the item of property, plant and equipment to which they relate, these assets may be grouped in determining the depreciation charge. Nevertheless, if it has been included in the cost of property, plant and equipment as a directly attributable cost, it will be depreciated over the useful lives of the said property, plant and equipment.

The useful lives of these assets should not exceed that of the asset to which it relates.

### Presentation

These assets should be presented within the class of asset to which they relate.

## Depreciation

SM 33.

### DEPRECIATION: METHOD



Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 2018 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:-

The notes to the financial statements state that plant and equipment is held under the 'cost model'. However, property which is owner occupied is revalued annually to fair value. Changes in fair value are sometimes reported in profit or loss but usually in 'other comprehensive income'. Also, the amount of

depreciation charged on plant and equipment as a percentage of its carrying amount is much higher than for owner occupied property. Another note states that property owned by ABC Ltd. but rent out to others is depreciated annually and not fair valued. Mr. Y is of the opinion that there is no consistent treatment of PPE items in the accounts. How should the finance controller respond to the query from the managing director?

**Ans.**

Ongoing through the query raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:

The accounting treatment of the majority of tangible non-current assets is governed by Ind AS 16 'Property, Plant and Equipment'. Ind AS 16 states that the accounting treatment of PPE is determined on a class by class basis. For this purpose, property and plant would be regarded as separate classes. Ind AS 16 requires that PPE is measured using either the cost model or the revaluation model. This model is applied on a class by class basis and must be applied consistently within a class. Ind AS 16 states that when the revaluation model applies, surpluses are recorded in other comprehensive income, unless they are cancelling out a deficit which has previously been reported in profit or loss, in which case it is reported in profit or loss. Where the revaluation results in a deficit, then such deficits are reported in profit or loss, unless they are cancelling out a surplus which has previously been reported in other comprehensive income, in which case they are reported in other comprehensive income.

According to Ind AS 16, all assets having a finite useful life should be depreciated over that life. Where property is concerned, the only depreciable element of the property is the buildings element, since land normally has an indefinite life. The estimated useful life of a building tends to be much longer than for plant. These two reasons together explain why the depreciation charge of a property as a percentage of its carrying amount tends to be much lower than for plant.

Properties which are held for investment purposes are not accounted for under Ind AS 16, but under Ind AS 40 'Investment Property'. As per Ind AS 40, investment properties should be accounted for under a cost model. ABC Ltd. had applied the cost model and thus our investment properties are treated differently from the owner occupied property.

**SM 34.**

**DEPRECIATION: REVISION OF USEFUL LIFE**

An asset which cost ₹ 10,000 was estimated to have a useful life of 10 years and residual value ₹ 2000. After two years, useful life was revised to 4 remaining years. Calculate the depreciation charge.

**Ans.**



	INR		
	Year-1	Year-2	Year-3
Cost	10,000.	10,000	10,000
Less: Accumulated Depreciation	(800)	(1,600)	(3,200)
Carrying Amount	9,200	8,400	6,800
Charges for year	$\frac{10,000 - 2,000}{10} = 800$	$\frac{10,000 - 2,000}{10} = 800$	$\frac{8,400 - 2,000}{4} = 1,600$

- The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.
- Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

**Revaluation**

**SM 35. REVALUATION : ENTIRE CLASS (REVALUATION MODEL FOR ENTIRE CLASS)**



Venus Ltd. is a large manufacturing group. It owns a considerable number of industrial buildings, such as factories and warehouses, and office buildings in several capital cities. The industrial buildings are located in industrial zones whereas the office buildings are in central business districts of the cities. Venus's Ltd. management want to apply the Ind AS 16 revaluation model to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. Is this acceptable under Ind AS 16, Property, Plant and Equipment?

**Ans.**

Venus's Ltd. management can apply the revaluation model to just the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. Ind AS 16 permits assets to be revalued on a class-by-class basis. The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can therefore be applied to these classes for subsequent measurement. All properties within the class of office buildings must therefore be carried at revalued amount. Separate disclosure of the two classes must be given in accordance with Ind AS 16.73.

**SM 36. REVALUATION: UTILISATION OF REVALUATION SURPLUS**



An item of PPE was purchased for ₹ 9,00,000 on 1 April 20X1. It is estimated to have a useful life of 10 years and is depreciated on a straight line basis. On 1 April 20X3, the asset is revalued to ₹ 9,60,000. The useful life remains unchanged at ten years.

Show the necessary treatment as per Ind AS 16.

**Ans.**

Calculation of Additional Depreciation:	(INR)
Actual depreciation for 20X3-20X4 based on revalued amount (9,60,000/8)	1,20,000
Depreciation for 20X4-20X5 based on historical cost (9,00,000/10)	(90,000)
Additional Depreciation	30,000

In the profit or loss for 20X3-20X4, a depreciation expense of ₹ 1,20,000 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be undertaken as follows:

Revaluation surplus Dr. 30,000

To Retained earnings 30,000

The closing balance on the revaluation surplus on 31 March 20X4 will therefore be as follows:

Balance arising on revaluation (9,60,000 – 7,20,000)	240,000
Transfer to retained earnings (30,000)	210,000

**PE 37. Special Limited is a multinational entity that owns 3 properties. All 3 properties were purchased on 1<sup>st</sup> April, 2020. The following details were furnished:**



Particulars	Property 1	Property 2	Property 3
Purchase Price	₹ 750,000	₹ 1,050,000	₹ 1,200,000
Estimated life	10 years	15 years	15 years
Fair value as on 31 <sup>st</sup> March, 2021	₹ 800,000	₹ 950,000	₹ 1,300,000



The Company uses Property 1 and Property 2 for its business purposes. The Company is exploring the opportunity to sell Property 3 if it gets reasonable consideration. Till the time it is not sold, the Company has rented the property.

It has adopted revaluation model for subsequent measurement of these properties. The depreciation is charged on straight line method. However, the Company has not charged any depreciation on Property 1 and Property 3 for the current year since the fair value of properties exceeds their carrying amount. The difference between their fair value and carrying amount has been recognized in the statement of profit and loss. The properties are shown under the head Property plant and equipment in the Balance sheet.

Analyze whether the accounting policies adopted by the Company in relation to the given properties are in accordance with Ind AS. If not, advise the correct treatment and present an extract of the Balance Sheet for the year ended 31<sup>st</sup> March 2021. [July-2021]

Ans.

**Preamble:**

The given issue needs to be examined in the umbrella of the provisions given in Ind AS 1 'Presentation of Financial Statements', Ind AS 16 'Property, Plant and Equipment' in relation to property '1' and '2' and Ind AS 40 'Investment Property' in relation to property '3'.

**Guidance given in relevant Ind AS:**

**1. Property '1' and '2'**

Definition and applicability:

As per Ind AS 16, Property plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services or for administrative purposes; and
- (b) are expected to be used during more than one period.

Hence, property 1 and 2 are held for use in the business, therefore Ind AS 16 shall apply in respect of these two properties.

**Accounting Principles:**

- If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an asset's carrying amount is decreased as a result of revaluation, the decrease shall be recognised in profit and loss statement.

**2. Property '3'**

**Definition and applicability:**

As per Ind AS 40, Investment property is property held to earn rentals or for capital appreciation or both, rather than for:

- Use in the production of goods or services or for administrative purposes; or
- Sale in the ordinary course of business.

Therefore, property 3 is an investment property and company shall follow cost model for its subsequent measurement.

**Accounting Principles:**

- An entity shall adopt as its accounting policy the cost model to all of its investment property; and (Refer paragraph 30 of Ind AS 40)
- requires that an entity shall disclose the fair value of investment property. ( Refer paragraph 79 (e) of Ind AS 40)



**CHAPTER  
7**
**IND AS ON ASSETS OF THE FINANCIAL  
STATEMENTS**
**UNIT  
3**
**Ind AS 116  
LEASES**
**MT 1.**
**SCOPE**


The Company has taken a particular application software of a supplier namely, Crystal Systems Limited, which is available on a cloud infrastructure managed and controlled by the Crystal Systems Limited. The Company contracts to pay a fee of ₹ 5,00,000 per month in exchange for a right to receive access to the Crystal Systems Limited's application software for 2 years. The Company accesses the software on need basis over the internet. The contract does not convey any rights to New Age Technology Limited over the tangible assets of the Crystal Systems Limited.

The Chief Accountant of New Age Technology Limited has sought your advice, whether the IT should account for this transaction for use of software with Crystal Systems Limited in terms of Ind AS 116 leases or an intangible asset in terms of Ind AS 38 'Intangible Assets'. Help him to understand your assessment. [MTP-May-2022]

**Ans.**

Assessment of applicability of Ind AS 38 in the given scenario

As per Ind AS 38, to be an intangible asset the asset should meet following criteria:

- Identifiability;
- Control over a Resource (Asset); and
- Existence of Future Economic Benefits.

Crystal Systems Limited manages and controls the application software available on a cloud infrastructure and New Age Technology Limited has limited rights to use the same. Merely right to access the application of Crystal Systems Limited, does not give New Age Technology Limited power to obtain future economic benefits flowing from the software itself. Hence, the application software should not be recognised as an asset under Ind AS 38.

**Assessment of applicability of Ind AS 116 in the given scenario**

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. This right to control the asset throughout the period of use is emphasized ONLY if the customer has both (i) right to obtain substantially all the economic benefits from the use of the identified asset, and (ii) the right to direct the use of the identified asset.

In the given case, the contract gives the New Age Technology Limited only the right to access the Crystal Systems Limited's application software over the contract term, and hence the contract is not a lease contract within the meaning of Ind AS 116.

**Conclusion**

The right to access the Crystal Systems Limited's application software for a price over a specified period is a service contract. If the Crystal Systems Limited pays amounts for which the services are yet to be received, then the advance payment is a prepayment and an asset for the Crystal Systems Limited.

**SM 2.**
**SHORT-TERM LEASE**
**Scenario A:**

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the

lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. Whether the lessee can take a short-term exemption in accordance with Ind AS 116?

**Scenario B:**

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

**Ans.**



**Scenario A:**

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

**Scenario B:**

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

**SM 3.**

**ASSET IMPLICITLY SPECIFIED IN A CONTRACT**



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

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

**Ans.**

Yes, the said rolling stock is an identified asset.

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

**SM 4.**

**ASSET IMPLICITLY SPECIFIED IN A CONTRACT**



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

Whether there is an identified asset?

**Ans.**

Yes, the said car is an identified asset.

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

**SM 5.**

**SUBSTANTIVE SUBSTITUTION RIGHTS**



**Scenario A:**

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

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

**Scenario B:**

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

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

**Ans.****Scenario A:**

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

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

**Scenario B:**

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

**SM 6.****IDENTIFIED ASSET – PHYSICALLY DISTINCT**

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

**Ans.**

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

**SM 7.****IDENTIFIED ASSET – NOT PHYSICALLY DISTINCT****Scenario A:**

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

Whether there is an identified asset?

**Scenario B:**

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

Whether there is an identified asset?

**Ans.****Scenario A:**

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

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer XYZ with the right to obtain substantially all of the economic benefits from use of the pipeline.

**Scenario B:**

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

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

**SM 8.****RIGHT TO USE FOR A PORTION OF THE TERM OF CONTRACT**

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

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

**Ans.**

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

**SM 9.****RIGHT TO OBTAIN SUBSTANTIALLY ALL OF THE ECONOMIC BENEFITS**

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

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

**Ans.**

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

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

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

**SM 10. RIGHT TO DIRECT THE USE OF AN ASSET**

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

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

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

**Ans.**

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

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

**SM 11. RIGHT TO DIRECT THE USE OF AN ASSET**

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

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

**Ans.**

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

**RT 12. IDENTIFIABLE ASSET****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 (I)**

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 (II)**

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? **[RTP-May-2022]**

**Ans.**

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."

"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 that 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 that 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.

**SM 13. RIGHT TO DIRECT THE USE OF AN ASSET**



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

**Ans.**

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

**SM 14. IDENTIFYING AND SEPARATING LEASE COMPONENTS**



**Scenario A:**

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

**Scenario B:**

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

**Ans.**

**Scenario A:**

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

**Scenario B:**

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

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

**SM 15. IDENTIFYING DIFFERENT COMPONENTS IN THE CONTRACT**



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

What are the units of account in the lease?

**Ans.**

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

The office building and HVAC system are one lease component because they cannot function

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

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

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

**SM 16.****ACTIVITIES WHICH ARE NOT COMPONENTS OF A LEASE CONTRACT****Scenario A:**

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

**Scenario B:**

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

**Ans.****Scenario A:**

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

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

**Scenario B:**

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

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

**SM 17.****ALLOCATING CONTRACT CONSIDERATION TO LEASE AND NON-LEASE COMPONENTS – LESSEES**

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

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

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

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

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

Ans.

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

Lease	* ₹ 76,500
Maintenance	** ₹ 13,500
Total	₹ 90,000
* ₹ 90,000 x 85%	
** ₹ 90,000 x 15%	

SM 18.

**DETERMINING THE LEASE TERM**

**Scenario A:**



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

**Scenario B:**

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

**Scenario C:**

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

Ans.

**Scenario A:**

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

**Scenario B:**

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

**Scenario C:**

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

**SM 19. RE-ASSESSMENT OF EXERCISE OF LEASE EXTENSION OPTION**

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

**Ans.**

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

**SM 20. RE-ASSESSMENT OF NON-CANCELLABLE PERIOD OF LEASE**

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

**Ans.**

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

**SM 21. DETERMINING THE FIXED PAYMENTS**

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

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

**Ans.**

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

**SM 22. IN SUBSTANCE FIXED LEASE PAYMENTS**

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

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

What is considered as lease payment in this case?

**Ans.**

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

**SM 23. IN-SUBSTANCE FIXED LEASE PAYMENT**



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

**Ans.**

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

**SM 24. IN SUBSTANCE FIXED LEASE PAYMENTS**

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

**Ans.**



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

**SM 25. VARIABLE LEASE PAYMENTS THAT DEPEND ON AN INDEX OR RATE**



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

**Ans.**

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated. At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108).

**SM 26. VARIABLE LEASE PAYMENTS THAT DO NOT DEPEND ON AN INDEX OR RATE**



Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each. The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract. Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract. Whether these payments affect the calculation of lease liability and ROU Asset? How does Entity XYZ and Customer ABC would allocate these lease payments?

**Ans.**

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

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

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract.

**SM 27.**

### VARIABLE LEASE PAYMENTS



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

**Ans.**

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

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

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

**SM 28.**

### RESIDUAL VALUE GUARANTEE INCLUDED IN LEASE PAYMENTS



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

**Ans.**

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

**SM 29.**

### INITIAL MEASUREMENT OF LEASE LIABILITY



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

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

**Ans.**

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

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

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

**SM 30.**

**MEASURING RIGHT-OF-USE ASSET**

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

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

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

How would Lessee Company measure and record this lease?

**Ans.**

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

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

**SM 31.**

**DISMANTLING COSTS TO BE INCLUDED IN INITIAL MEASUREMENT OF ROU ASSET**

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

**Ans.**

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

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



SM 32.

**LESSEE ACCOUNTING**

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

₹ 20,000 in year one

₹ 30,000 in year two

₹ 50,000 in year three.

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term. How would Entity ABC would account for the said lease under Ind AS 116?

**Ans.**

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

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

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

**Lease Liability**

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

\* Difference of ₹ 4 is due to approximation.

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

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

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

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

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

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

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

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

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

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

SM 33.

**SUBSEQUENT MEASUREMENT USING COST MODEL**

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

Ans.

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

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

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

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

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

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

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

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

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

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

### Working Notes

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

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

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

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

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

**PE 34.**

**REMEASUREMENT OF LEASE WITH VARIABLE LEASE PAYMENTS**



- Jakob Ltd. entered into a contract for lease of machinery with Jason Ltd. on 1.1.2018. The initial term of the lease is 6 years with a renewal option of further 2 years.
- The annual payments for initial term and renewal term are ₹ 2,80,000 and ₹ 3,50,000 respectively.
- The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 1.1.2019 will be based on the CPI available at 31.12.2018.
- Jakob Ltd.'s incremental borrowing rate at the lease inception date and as at 1.1.2021 is 8% and 10% respectively and the CPI at lease commencement date and as at 1.1.2021 is 250 and 260 respectively.
- At the lease commencement date, Jakob Ltd. did not think that it will be a viable option to renew the lease but in the first quarter of 2021, Jakob Ltd. made some major changes in the retail store which increases its economic life by five years.
- Jakob Ltd. determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Jakob Ltd. asked your opinion whether remeasurement of lease is required in the first quarter of 2021.

[Dec-2021]

**Ans.**

Since in the first quarter of 2021, Jakob Ltd. is reasonably certain that it will exercise its renewal option, it is required to re-measure the lease in the first quarter of 2021.

The following table summarizes information pertinent to the lease re-measurement:

Re-measured lease term	5 years (3 years remaining in the initial term plus 2 years in the renewal period)
Jakob Ltd.'s incremental borrowing rate on the re-measurement date	10%
CPI available on the re-measurement date	260
Right-of-use asset immediately before the re-measurement	₹ 6,99,019 (Refer note 2)
Lease liability immediately before the re-measurement	₹ 7,79,417 (Refer note 2)

**Procedure to re-measure the lease liability:**

To re-measure the lease liability, Jakob Ltd. would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 10%).

Since the initial lease payments were based on a CPI of 250, the CPI has increased by 4%  $[(260-250)/250 \times 100]$ . As a result, Jakob Ltd. would increase the future lease payments by 4%.

**Computation of present value of the future lease payments based on an updated CPI of 260:**

	Year					Total
	4	5	6	7	8	
Lease payment	2,91,200	2,91,200	2,91,200	3,64,000	3,64,000	16,01,600
Discount @ 10%	1	0.909	0.826	0.751	0.683	
Present value	2,91,200	2,64,701	2,40,531	2,73,364	2,48,612	13,18,408

Calculation of the adjustment to the lease liability on re-measurement by comparing the recalculated and original lease liability balances on the re-measurement date:

Revised lease liability	13,18,408
Original lease liability	<u>(7,79,417)</u>
Adjustment to the lease liability on re-measurement	<u>5,38,991</u>

Based on above calculations, it is clear that re-measurement of lease is required and accordingly adjustment to lease liability and ROU asset is required in the first quarter of 2021.

**Journal entry to adjust the lease liability**

ROU Asset	Dr.	5,38,991	
To Lease liability			5,38,991
(Being lease liability and ROU asset adjusted on account of re-measurement)			

**Working Notes:**

**1. Calculation of ROU asset before the date of re-measurement**

Year beginning	Lease Payment (A)	Present value factor @ 8% (B)	Present value of lease payments (A x B = C)
1	2,80,000	1.000	2,80,000
2	2,80,000	0.926	2,59,280
3	2,80,000	0.857	2,39,960
4	2,80,000	0.794	2,22,320
5	2,80,000	0.735	2,05,800
6	2,80,000	0.681	1,90,680
Lease liability as at the commencement date			<u>13,98,040</u>

(2,80,000 x Sum of PV (4.993) @ 8% for 5 years = 13,98,040)

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 8%	Closing balance	Initial Value	Depreciation for 6 years	Closing balance
	a	b	c = (a-b) x 8%	d = a-b+c			
1	13,98,040	2,80,000	89,443	12,07,483	13,98,040	2,33,007	11,65,033
2	12,07,483	2,80,000	74,199	10,01,682	11,65,033	2,33,007	9,32,026
3	10,01,682	2,80,000	57,735	7,79,417	9,32,026	2,33,007	6,99,019
4	7,79,417				6,99,019		

As per the information given in the third bullet point at page 10, it is inferred that annual lease payments are due at the beginning of the year. Hence, it can be inferred that the annual lease payment of 2021 had been paid on 1.1.2021. Accordingly lease liability considered for the purpose of remeasurement would be of 5th, 6th, 7th and 8th year only i.e. for 4 years. However, since remeasurement has been decided in the first quarter of 2021, ROU asset balance before remeasurement will be after depreciation of 3 years i.e. till 2020.

Based on the above contention, following **alternative solution** is also possible:

Since in the first quarter of 2021, Jakob Ltd. is reasonably certain that it will exercise its renewal option, it is required to re-measure the lease in the first quarter of 2021.

The following table summarizes information pertinent to the lease re-measurement:

<b>Re-measured lease term</b>	<b>4 years (2 years remaining in the initial term plus 2 years in the renewal period)</b>
Jakob Ltd.'s incremental borrowing rate on the re-measurement date	10%
CPI available on the re-measurement date	260
Right-of-use asset immediately before the re-measurement	₹ 6,99,019 (Refer note 2)
Lease liability immediately before the re-measurement	₹ 5,39,370 (Refer note 2)

#### Procedure to re-measure the lease liability:

To re-measure the lease liability, Jakob Ltd. would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 10%).

Since the initial lease payments were based on a CPI of 250, the CPI has increased by 4%  $[(260-250)/250 \times 100]$ . As a result, Jakob Ltd. would increase the future lease payments by 4%.

#### Computation of present value of the future lease payments based on an updated CPI of 260:

	Year				Total
	5	6	7	8	
Lease payment	2,91,200	2,91,200	3,64,000	3,64,000	13,10,400
Discount @ 10%	1	0.909	0.826	0.751	
Present value	2,91,200	2,64,701	3,00,664	2,73,764	11,30,329

Calculation of the adjustment to the lease liability on re-measurement by comparing the recalculated and original lease liability balances on the re-measurement date:

Revised lease liability	11,30,329
Original lease liability	<u>(5,39,370)</u>
Adjustment to the lease liability on re-measurement	<u>5,90,959</u>

Based on above calculations, it is clear that re-measurement of lease is required and accordingly adjustment to lease liability and ROU asset is required in the first quarter of 2022.

#### Journal entry to adjust the lease liability

ROU Asset	Dr.	5,90,959	
To Lease liability			5,90,959
(Being lease liability and ROU asset adjusted on account of re-measurement)			

#### Working Notes:

##### 1. Calculation of ROU asset before the date of re-measurement

Year beginning	Lease Payment (A)	Present value factor @ 8% (B)	Present value of lease payments (A x B = C)
1	2,80,000	1.000	2,80,000
2	2,80,000	0.926	2,59,280
3	2,80,000	0.857	2,39,960
4	2,80,000	0.794	2,22,320
5	2,80,000	0.735	2,05,800
6	2,80,000	0.681	<u>1,90,680</u>
Lease liability as at commencement date			<u>13,98,040</u>

Or

(2,80,000 x sum of PV (4.993) @ 8% for 5 years = 13,98,040)

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 8%	Closing balance	Initial Value	Depreciation for 6 years	Closing balance
	a	b	c = (a-b) x 8%	d = a-b+c			
1	13,98,040	2,80,000	89,443	12,07,483	13,98,040	2,33,007	11,65,033
2	12,07,483	2,80,000	74,199	10,01,682	11,65,033	2,33,007	9,32,026
3	10,01,682	2,80,000	57,735	7,79,417	9,32,026	2,33,007	6,99,019
4	7,79,417	2,80,000	39,953	5,39,370	6,99,019		
5	5,39,370						

SM 35.

### REMEASUREMENT OF A LEASE WITH VARIABLE LEASE PAYMENTS



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

Entity W's incremental borrowing rate at the lease inception date and as at 01/01/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 01/01/20X4 is 120 and 125 respectively. At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 20X4, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

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

Ans.

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

The following table summarizes information pertinent to the lease remeasurement.

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

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

Year	4	5	6	7	8	Total
Lease payment	1,04,167	1,04,167	1,14,583	1,14,583	1,14,583	5,52,083
Discount	1	0.943	0.890	0.840	0.792	
Present value	1,04,000	98,230	1,01,979	96,250	90,750	4,91,376

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

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

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

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

**Working Notes:**

**1 Calculation of ROU asset before the date of remeasurement**

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

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 5%	Closing balance	Initial Value	Depreciation for 5 years	Closing balance
1	4,54,60	1,00,000	17,730	3,72,330	4,54,600	90,920	3,63,680
2	3,72,33	1,00,000	13,617	2,85,947	3,63,680	90,920	2,72,760
3	2,85,94	1,00,000	9,297	1,95,244	2,72,760	90,920	1,81,840
4	1,95,24				1,81,840		

**RT 36.**

**REMEASUREMENT: VARIABLE LEASE PAYMENT : INDEX RELATED**



The Company has entered into a lease agreement for its retail store as on 1st April, 20X1 for a period of 10 years. A lease rental of ₹ 56,000 per annum is payable in arrears. The Company recognized a lease liability of ₹ 3,51,613 at inception using an incremental borrowing rate of 9.5% p.a. as at 1<sup>st</sup> April 20X1. As per the terms of lease agreement, the lease rental shall be adjusted every 2 years to give effect of inflation. Inflation cost index as notified by the Income tax department shall be used to derive the lease payments. Inflation cost index was 280 for financial year 20X1-20X2 and 301 for financial year 20X3-20X4. The current incremental borrowing rate is 8% p.a.

Show the Journal entry at the beginning of year 3, to account for change in lease.

[RTP-Dec-2021]



**Ans.**

As per para 27 (b) of Ind AS 116, variable lease payments that depend on an index or a rate, are initially measured using the index or rate as at the commencement date.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of ₹ 60,200 discounted at an original discount rate of 9.5% per annum as per para 43 of Ind AS 116.

Year	Revised lease rental	Discount factor @ 9.5%	Present value
3	$[(56,000 / 280) \times 301] = 60,200$	0.913	54,963
4	60,200	0.834	50,207
5	60,200	0.762	45,872
6	60,200	0.696	41,899
7	60,200	0.635	38,277
8	60,200	0.580	34,916
9	60,200	0.530	31,906
10	60,200	0.484	<u>29,137</u>
			<b><u>3,27,127</u></b>

Table showing amortised cost of lease liability

Year	Opening balance	Interest @ 9.5%	Rental paid	Closing balance
1	3,51,613	33,403	56,000	3,29,016
2	3,29,016	31,257	56,000	3,04,273

Difference of ₹ 22,854 (3,27,127 – 3,04,273) will increase the lease liability with corresponding increase in ROU Asset as per para 39 of Ind AS 116.

**Journal entry at the beginning of year 3 would be:**

Right-of-use asset	Dr.	₹ 22,854	
To Lease liability			₹ 22,854

**SM 37.****MODIFICATION THAT IS A SEPARATE LEASE**

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

**Ans.**

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

SM 38.



**MODIFICATION THAT INCREASES THE SCOPE OF THE LEASE BY EXTENDING THE CONTRACTUAL LEASE TERM**

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

How should the said modification be accounted for?

[MTP-May-2022]

Ans.

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

- (a) An eight-year remaining lease term
- (b) Annual payments of ₹ 1,00,000 and
- (c) Lessee's incremental borrowing rate of 7% p.a.

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

**Working Notes:**

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

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

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

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

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

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

### 4. Adjustment to ROU asset:

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

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

**SM 39.**

### MODIFICATION THAT DECREASES THE SCOPE OF THE LEASE

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a. How should the said modification be accounted for?

**Ans.**

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

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

\*(refer note 1)

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

(a) a five-year remaining lease term,

- (b) annual payments of ₹ 30,000 and  
(c) Lessee's incremental borrowing rate of 5% p.a.

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

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

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

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

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

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

**Working Note:**

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

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

**MT 40.**

**MODIFICATION : REDUCTION IN SCOPE**

Buildings Limited entered into a 10-year lease for 6,000 square meter of office space. The annual lease payments are ₹ 60,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Buildings Limited's incremental borrowing rate at the commencement date is 8% p.a. At the beginning of 6th year, Buildings Limited and lessor agree to amend the original lease to reduce the space to only 3,000 square meters of the original space starting from the end of the first quarter of year 6. The annual fixed lease payments (from year 6 to year 10) are ₹ 35,000. Buildings Limited's incremental borrowing rate at the beginning of year 6 is 6% p.a.

The CFO of the Company has requested your suggestion on how to account for the modification in the lease of office space? Prepare the detailed working for the modification. **[MTP-May-2021]**



Ans.

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 8%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 8%	d = a-b + c	e	f	g
1	4,02,600*	60,000	32,208	3,74,808	4,02,600	40,260	3,62,340
2	3,74,808	60,000	29,985	3,44,793	3,62,340	40,260	3,22,080
3	3,44,793	60,000	27,583	3,12,376	3,22,080	40,260	2,81,820
4	3,12,376	60,000	24,990	2,77,366	2,81,820	40,260	2,41,560
5	2,77,366	60,000	22,189	2,39,555	2,41,560	40,260	2,01,300
6	2,39,555				2,01,300		

\* Initial value of ROU asset and lease liability = Annual lease payment x annuity factor @ 8%  
= 60,000 x 6.71 = ₹ 4,02,600

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

- A five-year remaining lease term,
- Annual payments of ₹ 35,000 and
- Lessee's incremental borrowing rate of 6% p.a.

Present value of modified lease = Annual lease payment x annuity factor @ 6% = 35,000 x 4.212 = 1,47,420

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 3,000 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 2,01,300) is ₹ 1,00,650

50% of the pre-modification lease liability (₹ 2,39,555) is ₹ 1,19,777.50.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,00,650 and the carrying amount of the lease liability by ₹ 1,19,777.50. Lessee recognises the difference in the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,19,777.50 – ₹ 1,00,650 = ₹ 19,127.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of ₹ 1,19,777.50 and the modified lease liability of ₹ 1,47,420 (which equals ₹ 27,642.50) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

SM 41.

#### MODIFICATION THAT IS A CHANGE IN CONSIDERATION ONLY

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

Ans.

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

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857

3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090			

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

- a five-year remaining lease term,
- annual payments of ₹ 95,000, and
- Lessee's incremental borrowing rate of 7% p.a.

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

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

#### Working Note:

Calculation of Initial value of ROU asset and lease liability:

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

#### SM 42.

#### MODIFICATION THAT BOTH INCREASES AND DECREASES THE SCOPE OF THE LEASE



Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

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

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

How should the said modification be accounted for?

Ans.

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

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

\*Refer Note 4.

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

- (a) A three-year remaining lease term (i.e. till 8th year), (b) Annual payments of ₹ 1,50,000 and (c) Lessee's incremental borrowing rate of 7% p.a.

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

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

#### Decrease in the lease term:

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

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

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee

recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

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

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

\*(Refer note 3)

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

**Increase in the leased space:**

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

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

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

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

\*Difference is due to approximation.

\*\*Refer Note 5

**Working Notes:**

**1 Calculation of lease liability on increased consideration:**

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



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

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

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

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

- 4 Calculation of Initial value of ROU asset and lease liability:

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

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

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

SM 43.

#### LESSOR ACCOUNTING FOR A FINANCE LEASE → DEALER-LESSOR CASE

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

- Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year
- Lessor expects the residual value of the equipment to be ₹ 50,000 at the end of the 10-year lease term



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

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

**Ans.**

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

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

Net investment in the lease	₹ 1,11,000 <sup>(a)</sup>	
Cost of goods sold	₹ 92,340 <sup>(b)</sup>	
Revenue		₹ 1,03,340 <sup>(c)</sup>
Property held for lease		₹ 1,00,000 <sup>(d)</sup>

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

- (a) The net investment in the lease consists of:
- (1) the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) AND
  - (2) the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).

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

- (b) Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.
- (c) Revenue equals the lease receivable.
- (d) The carrying amount of the underlying asset.

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

**Year 1 Journal entry for a finance lease**

Cash	₹ 15,000(e)	
Net investment in the lease		₹ 3,813(f)
Interest income		₹ 11,187(g)

- (e) Receipt of annual lease payments at the end of the year.
- (f) Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187
- (g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:

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

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

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

#### Working Notes:

##### 1 Calculation of net investment in lease:

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

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

##### 2 Calculation of present value of unguaranteed residual asset

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

#### SM 44.

#### CLASSIFICATION OF A SUBLEASE IN CASE OF AN INTERMEDIATE LESSOR

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

How should the said sublease be classified by Entity ABC?

Ans.



The sublease is classified with reference to the 'ROU Asset' in the head lease (and NOT the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (NOT compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

SM 45.

**INTERMEDIATE LESSOR – WHERE THE SUBLEASE IS CLASSIFIED AS A 'FINANCE LEASE'**

**Head lease:**

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

**Sublease:**

At the beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e three years of the head lease to a sub-lessee.

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

Ans.

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as a finance lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease).

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

- (i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;
- (ii) recognises any difference between the ROU asset and the net investment in the sublease in profit or loss; AND
- (iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

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

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

SM 46.

**INTERMEDIATE LESSOR – WHERE THE SUBLEASE IS CLASSIFIED AS A 'OPERATING LEASE'**

**Head lease:**

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

**Sublease:**

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

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

Ans.

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

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

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

both relating to the head lease in its balance sheet.

During the term of the sublease, the intermediate lessor:

- (a) recognises a depreciation charge for the ROU asset and interest on the lease liability; AND  
 (b) recognises lease income from the sublease.

### Sub-lessee Accounting:

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

SM 47.

### SALE AND LEASEBACK TRANSACTION

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

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

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

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

**Ans.**

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

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

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

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

### Proportion of annual lease payments:

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

### Seller-Lessee:

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

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

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

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

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

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

**Buyer-Lessor:**

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

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

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

- (a) payments received to settle the financial asset of ₹ 3,00,000 AND
- (b) interest revenue.

**SM 48.**

**TRANSITION APPROACHES**



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

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

Modified Retrospective Approach

- Alternative 1
- Alternative 2

[MTP-Dec-2021]

Ans.

**Full Retrospective Approach:**

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

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

**Lease Liability Schedule:**

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

\*Difference is due to approximation

**ROU Asset Schedule:**

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

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

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

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-20 is the first year of adoption and using Full retrospective method the comparative for 2018-19 needs to be restated and 1st April 2018 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1 April 2018 (assuming that only the 2018-19 financial information is included as comparatives).

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

The following journal entries would be recorded during 2018-19:

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

The following journal entries would be recorded during 2019-20:

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

**Modified Retrospective Approach (Alternative 1):**

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

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

**Lease Liability Schedule:**

Year	Opening Balance	Interest Expense @ 10%	Payments	Closing Balance
31 Mar 2020	1,81,820	18,182	(2,00,000)	-



**ROU Asset Schedule:**

Year	Opening Balance	Depreciation	Closing Balance
31 Mar 2020	1,65,790***	(1,65,790)	-

\*\*\*(Refer note no 3)

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

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,737	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
01 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

\*(Refer note no 1)

\*\* (Refer note no 2)

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

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

The following journal entries would be recorded during 2019-20:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
To record interest expense and accrete the lease liability using the interest method.			

Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
To record depreciation expense on the ROU asset.			

Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

**Note 1:**
**Calculation of Present value of lease payments as at commencement date i.e., 01/04/2017**

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

**Lease Liability Schedule:**

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

\*Difference is due to approximation

Calculation of ROU asset as at transition date i.e., April 01, 2019

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

**Modified Retrospective Approach (Alternative 2):**

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 01 April 2019 to 31 March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

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

**Lease Liability Schedule:**

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

**ROU Asset Schedule:**

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