IND AS 116 - leases

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Scope

An entity shall apply this standard to all leases, except for:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Leases of biological assets within the scope of Ind AS 41 Agriculture held by a lessee;
- Service concession arrangements within the scope of Appendix D of Ind AS 115 ;
- Licences of intellectual property granted by a lessor within the scope of Ind AS 115 Revenue from Contracts with Customers
- Rights held by a lessee under licensing agreements within the scope of Ind AS 38 intangible assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

RECOGNITION EXEMPTION

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

- Short-term leases; and
- Leases for which the underlying asset is of low value ('low value lease').

Recognition exemption

An underlying asset can be low value only if:

- The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and
- The underlying asset is not highly dependent on, or highly interrelated with other assets.

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

Short-term leases	➢ Lease term is 12 months or less ➢ No Purchase Option ➢ Factor in lessee options to terminate or extend lease if exercise is reasonable certain ➢ Apply consistently by class of underlying asset
Low value leases	➢ Assess based on value of an equivalent new asset; ➢ Not judged by reference to materiality ➢ Made on a lease by lease basis ➢ The lessee can benefit from use of the asset; ➢ Underlying asset is not highly dependent / interrelated to other assets



Definition of 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.

Identified Asset: *An asset can be either explicitly specified in contract or implicitly specified at the time it is made available for use.*

How do you assess whether a contract conveys the right to control the use of an identified asset?

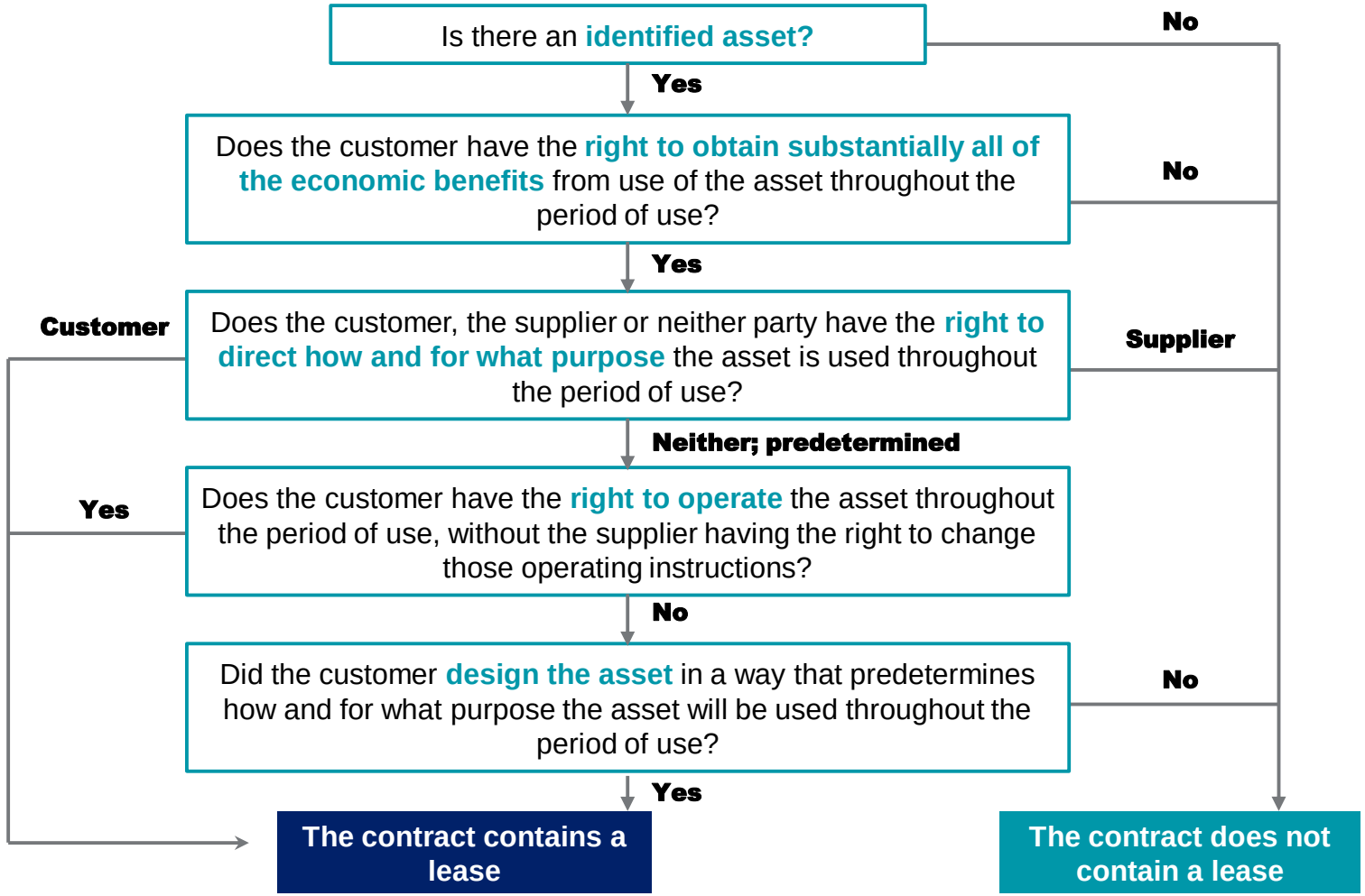
To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

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.



Assessing whether a contract is, or contains, a lease



Identified asset – substitution rights

A supplier's right would be substantive if both of the following conditions are met:

- The supplier has the **practical ability to substitute alternative assets** throughout the period of use:

AND

- The supplier **would benefit economically** from the exercise of its right to substitute the asset

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a customer shall presume that any substitution right is not substantive.

Scenario

Customer enters into a 10 year contract with a freight carrier (Supplier) to transport Customer's goods.

The contract requires the supplier to use rail cars of a particular specification and it will require 20 rail cars to transport the required quantity of goods over the 10 year term of contact.

Supplier has a large pool of rail cars that can be used to fulfil the contract. All rail cars are stored at Supplier's premises when they are not being used to transport goods. Costs associated with substituting the rail cars are minimal for Supplier.

Are Supplier's substitution rights substantive?



Identified asset – substitution rights

Discussion

In this case, the contract does not contain identified assets.

The supplier has a large pool of rail cars available, and it can use any of the pool to satisfy the contact.

If, in contrast, the rails cars were stored some distance away at, say, the customer's premises, such that the supplier would have to incur significant costs to substitute those rail cars which would outweigh the potential benefits of substitution, then the substitution would not be substantive. It would then be necessary to consider the other guidance in Ind AS 116 in order to conclude whether the contact is, or contains, a lease.

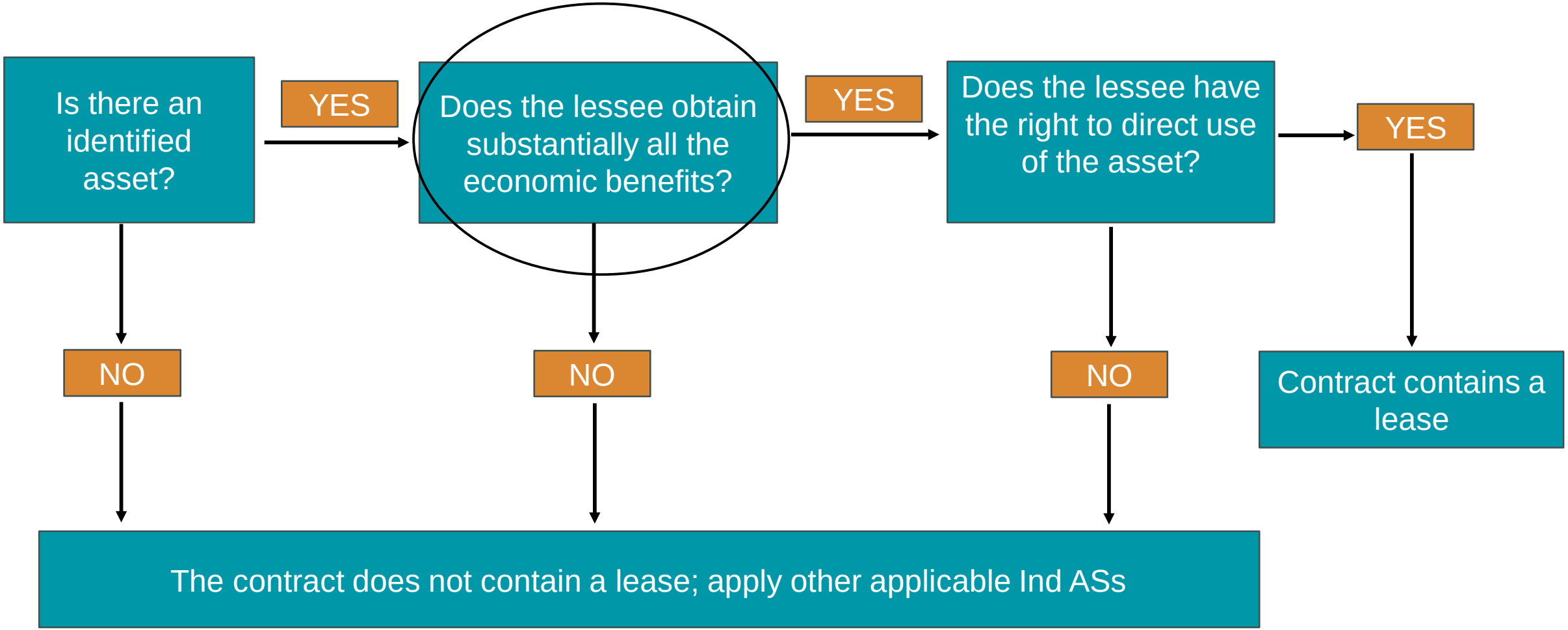
- Is the portion of an asset physically distinct?

✓ Yes. Then it is an identified asset.

? No. It might be a lease if it represents substantially all of the capacity of the asset.



Right to control the use of an asset



Economic benefits

Scenario I

A retailer enters into a contract with a lessor for the lease of retail space in a shopping centre for 5 years. The lease payments are equal to 20% of the gross sales revenue of the sales. The lessee has the right to determine which products are to be sold and the design of the store.

Who has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?

Discussion

In this case, it is the customer's control and use of the property which generates all of the sales revenue. The lessee has a right to 100% of the sales revenue generated from the store.

This represents all of the economic benefits that will be generated by the store over the period of use, even though it has negotiated a contract which results in rental payments being a percentage of sales revenue.

This type of contractual term is common in leases of retail real estate.



Economic benefits

Scenario II

Customer enters into a 10- year contract with Power Company Supplier to purchase all of the electricity produced by a new solar farm.

Supplier owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and the customer will receive renewable energy credits that accrue from use of the solar farm.

Who has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?

Discussion

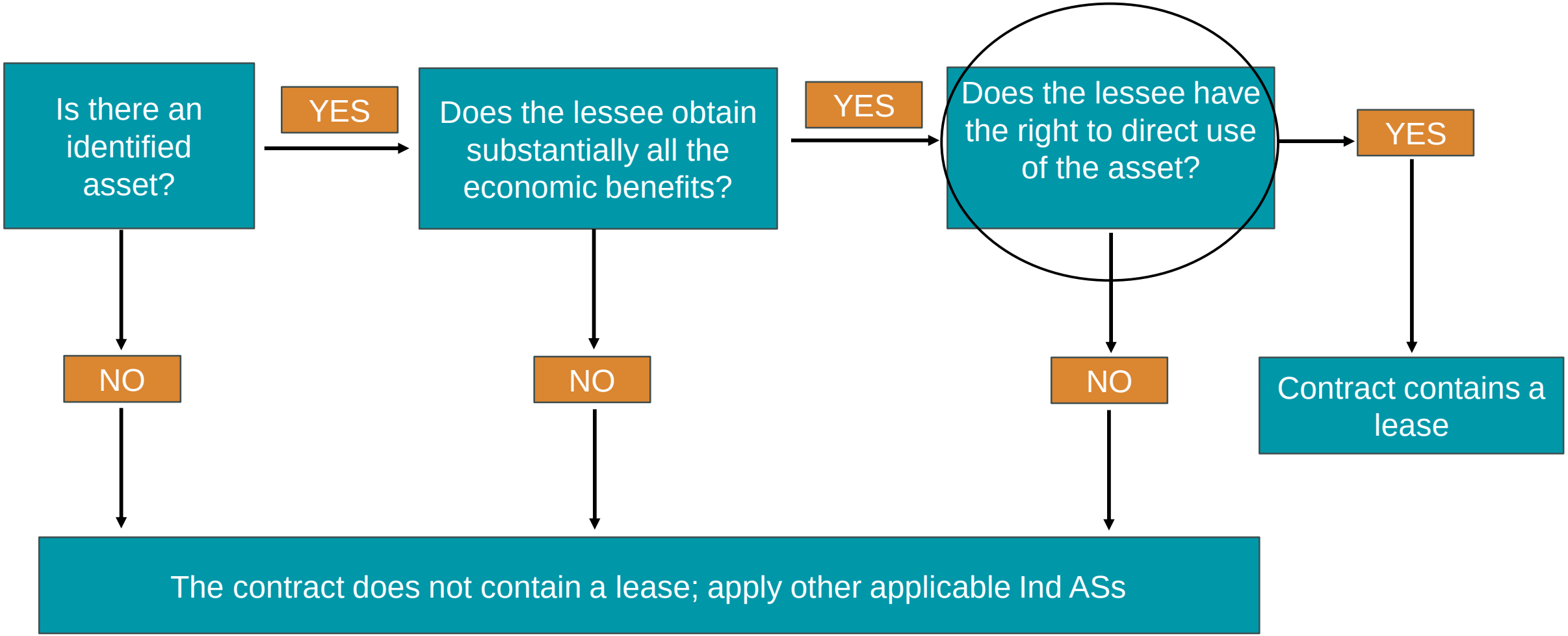
The customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 10-year period because it obtains:

- The electricity produced by the farm over the lease term – i.e. the primary output from use of the asset; and
- The renewable energy credits, which are a by-product from use of asset.

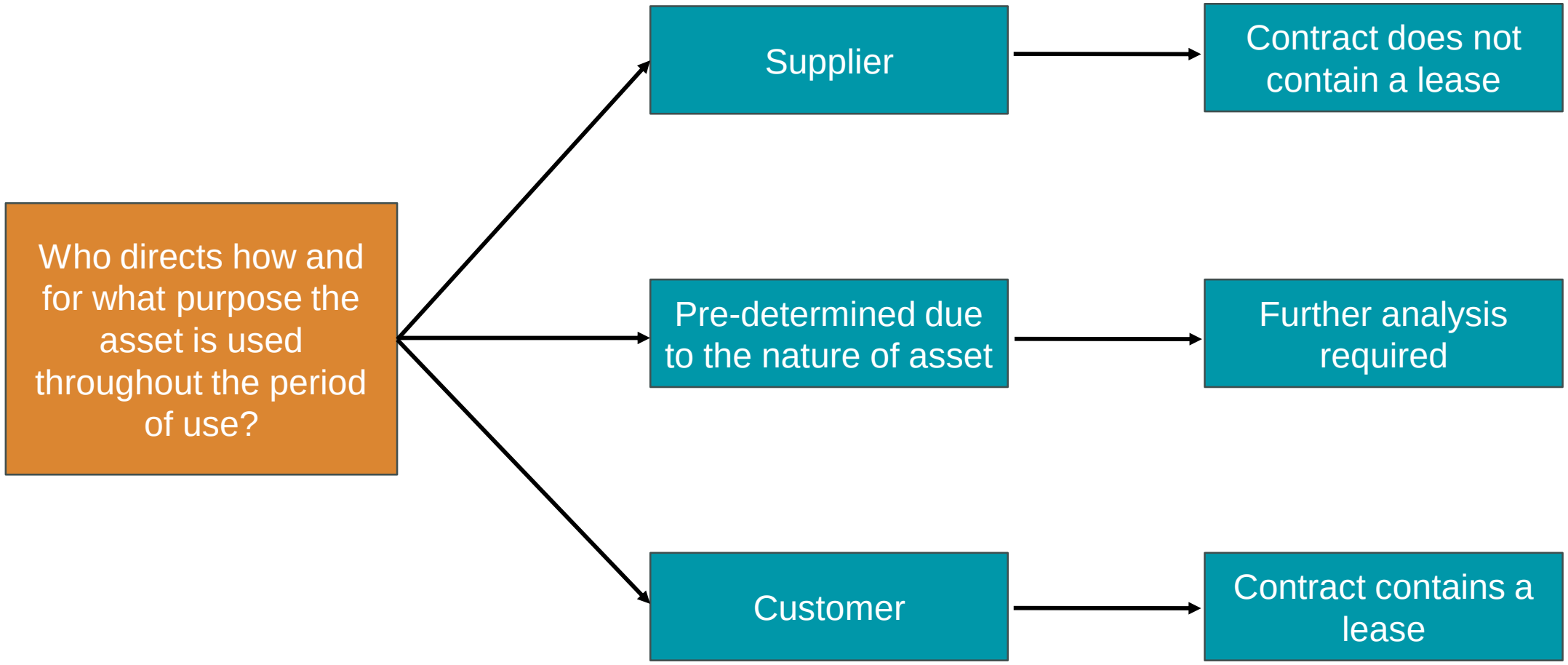
Although the lessor receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to legal ownership of the solar farm. They are not derived from the use of the solar farm and therefore are not relevant to the assessment of economic benefits that is required by Ind AS 116.



Right to control the use of an asset



Right to direct use



Economic benefits

Scenario

A customer enters into a contract with a supplier where the customer will purchase at least 80% of the energy produced by a bio-mass facility.

The contract specifies that the energy must be produced from this particular facility. The supplier is responsible for building, operating, and maintaining the facility to the customer's specification.

The customer designed the bio-mass facility before it was constructed and hired experts to assist in determining the location of the facility and the engineering of the equipment to be used.

There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Discussion

Neither the customer nor the supplier has the right to direct use of the asset during the period of its use, because the functionality of the facility is predetermined based on its design.

However, the customer's design of the bio-mass facility gives it the right to direct how and for what purpose the asset is used.

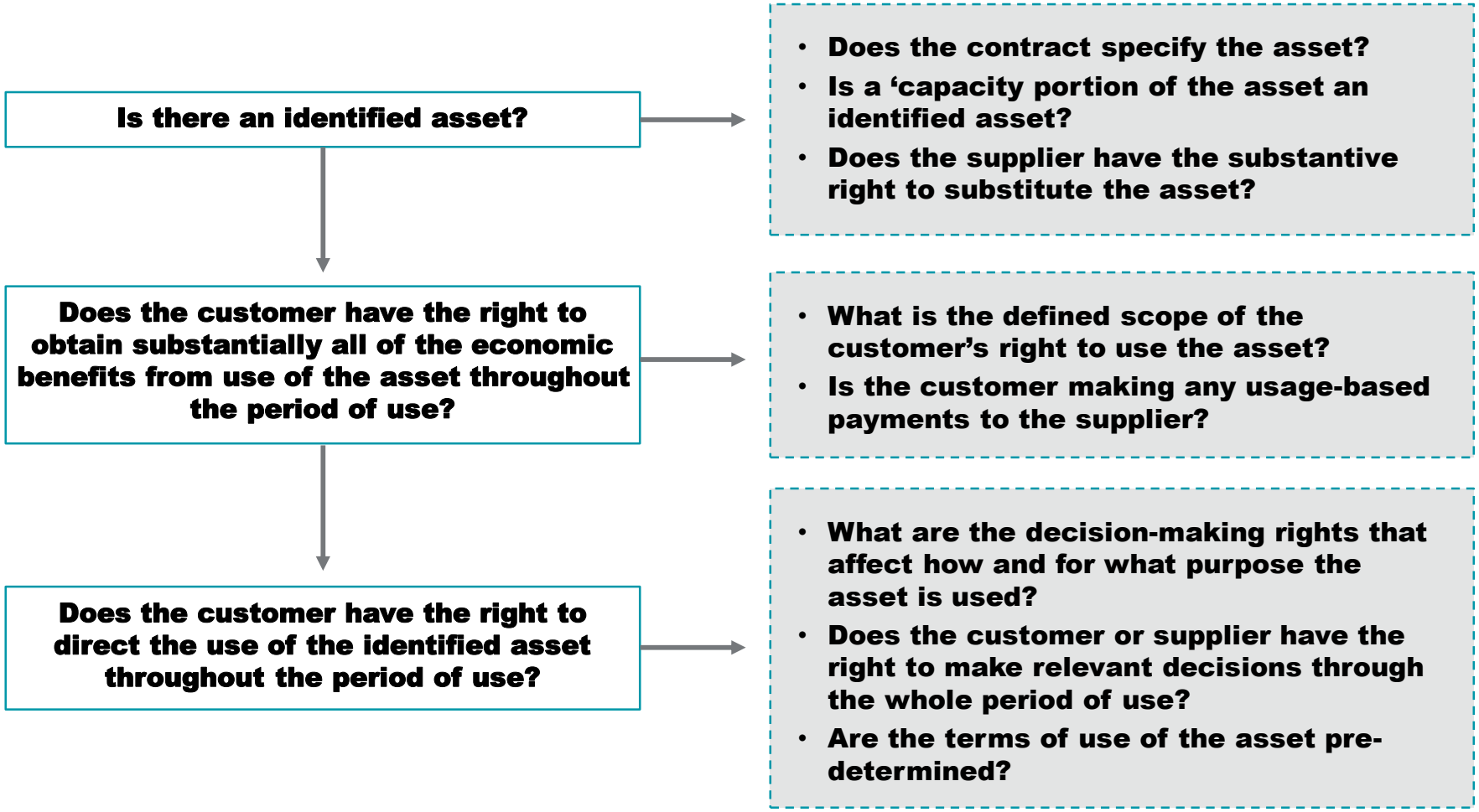
The customer's control over the design is equivalent to the customer having control over those decisions.

In addition, as the bio-mass facility is clearly identified and, through the purchase of 100% of the energy produced the customer obtains substantially all of the economic benefits from the facility, the contract contains a lease.

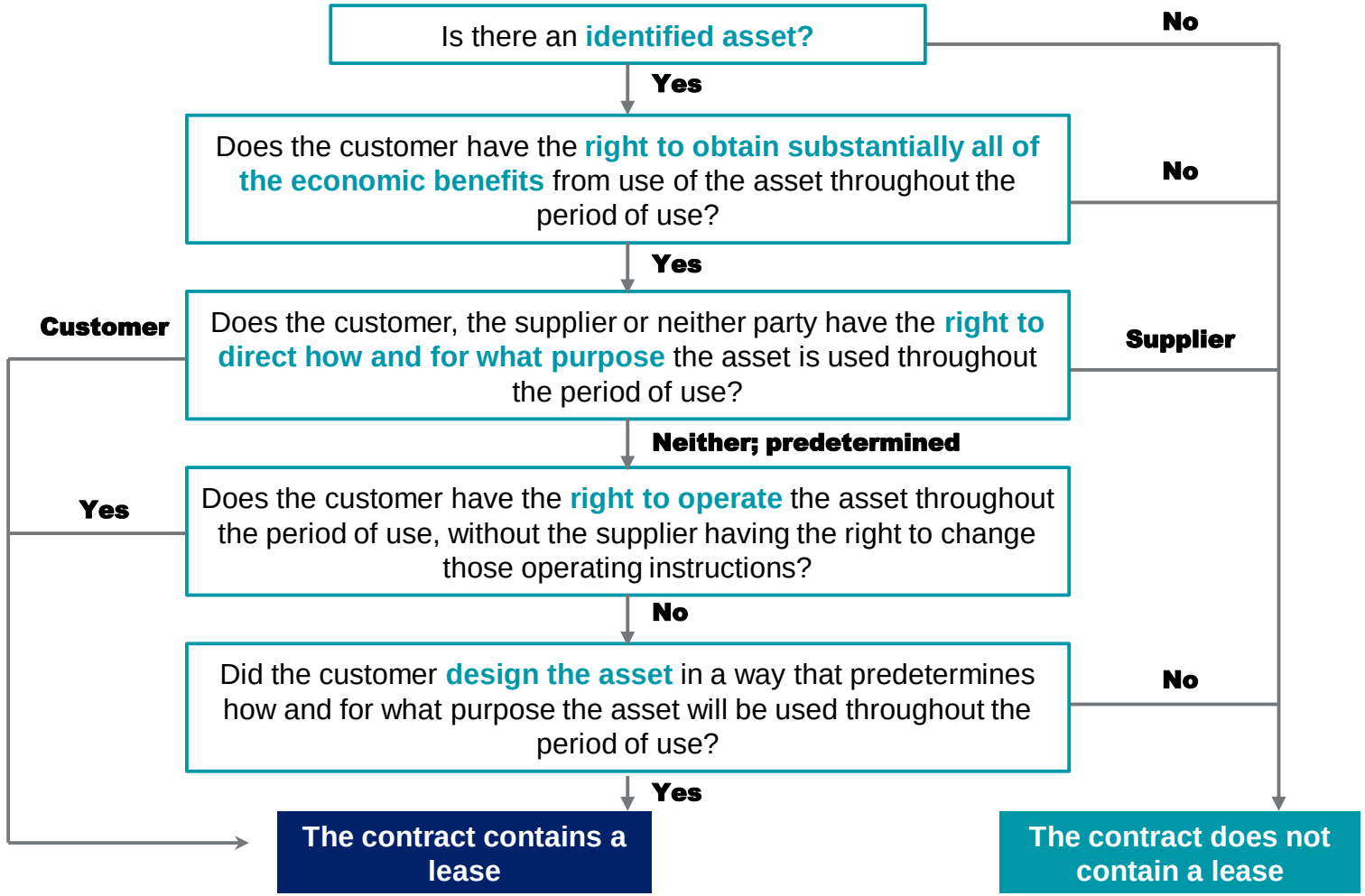


Recap - Identifying a lease contract

Key considerations



Assessing whether a contract is, or contains, a lease



Case study 1

Does the contract contain a lease?

Background:

- An Automobile Company intends to operate a small desk in the airport to sell and advertise its Cars.
- The Company entered into negotiations with the airport terminal operators (O.T.G. Limited “OTG”) and they recently signed a contract in respect of same.
- The contract provides the Company with the right to use a space in the airport to advertise and promote its Cars.
- The contract is for a three-year period commencing.
- The contract terms and conditions note that the Company will have access to an area of space equal to 10 square meters and space will be located outside the main arrival doors in any one of the several terminal buildings within the airport.
- The contract also states that OTG will retain the right to change the location of the space allocated to the Company at any time during the period of use.
- OTG will incur minimal costs in respect of a relocation.
- The Company can use the space in whatever capacity they require.

No. Although the area of space the Company uses is specified in the contract, the actual location of the space is not specified and can change at the discretion of OTG. Therefore, there is no identified asset specified in the contract.

Case study 2

Does the contract contain a lease?

Background:

- An Automobile Company enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality and quantity of an automobile part for a three-year period.
- Identified asset: Factory implicitly specified because Supplier can fulfil the contract only through the use of its one factory.
- Substantive substitution rights: No alternative factory available.
- Customer has a right to control the use of the identified asset: Customer does not have the right to obtain all of the economic benefits from use of the factory during the contract period because its output does not represent substantially all of the output of the factory and Supplier can use spare capacity to supply other customers. Also, Supplier directs the use of the factory (Customer has the same rights as other customers).

No. Customer is purchasing automobile part (goods).

Case study 3

Does the contract contain a lease?

Background:

- An Automobile Company enters into a contract with an information technology company (Supplier) for the use of an identified server for three years.
- Identified asset: Specific server identified in the contract.
- Substantive substitution rights: Server can only be substituted if it malfunctions.
- Customer has a right to control the use of the identified asset: Customer has exclusive use and has the right to obtain all of the economic benefits from use of the server during the contract period. Customer makes the relevant decisions about how and for what purpose the server is used.

Yes – lease of the server for the contract period.

Case study 4

Does the contract contain a lease?

Background:

- Contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for five years. Supplier also provides engines and drivers when requested by Customer.
- Identified asset: Specific rail cars identified in contract.
- Substantive substitution rights: Can only be substituted for repairs or maintenance.
- Customer has a right to control the use of the identified asset: Customer has exclusive use of rail cars during the contract period so that it has the right to substantially all of the economic benefits from use of the rail cars. Customer has the right to change how and for what purpose the cars are used – it directs when and where the cars are used, and which goods are transported. Supplier's rights (restrictions on specified types of cargo) are protective only. Supplier's control of engines required to transport the rail cars does not give it the right to control the use of the cars.

Yes – lease of rail cars (not engines).

Contracts with multiple components

Contracts may have multiple components

Lease and non-lease components

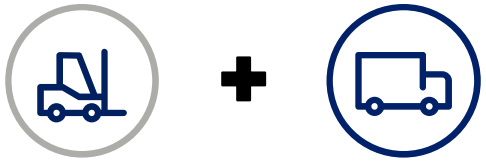


- Identify the non-lease components and account for these separately from the lease components.

Multiple lease components

if

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



Accounting for a contract with multiple components

Stand-alone selling price (“SASP”)

The SASP for a component is:



The price the lessor, or a similar supplier, would sell the promised good or service separately to a customer.

DEFINITION

Commercially sensitive, may not be readily available



JUDGEMENT

If the observable stand-alone price is not readily available, the lessee should make an estimate, maximizing the use of observable information.

Estimation methods include for example:

- Adjusted market assessment approach,
- Expected costs plus margin approach, and
- The residual approach.

Observable information might be:

- Market-conditions,
- Information of customer / class of customer, and
- Other entity-specific conditions.

What is a lease term?



DEFINITION

The lease term is determined at the lease commencement date based on the non-cancellable term of the lease, including:

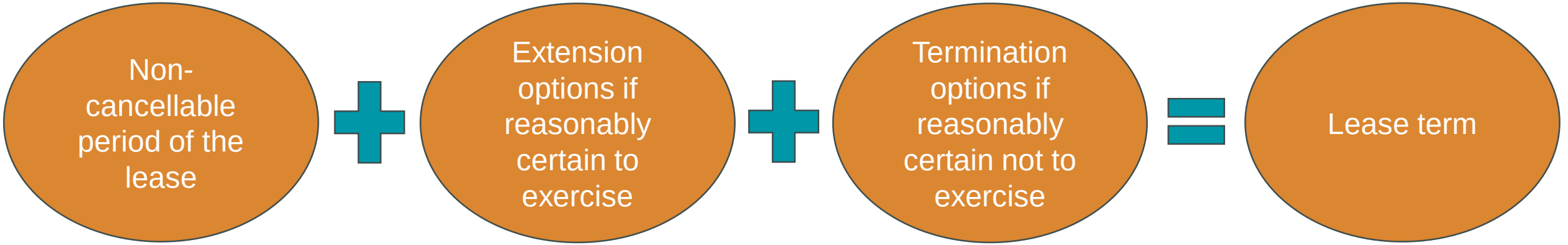
- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.



JUDGMENT

- Assessment of ‘reasonably certain’ is **judgmental.**
- Consider all the relevant **facts and circumstances** that create an economic incentive for the lessee (e.g. contractual terms and conditions; significant leasehold improvements; costs of termination the contract etc.).

DETERMINING THE LEASE TERM

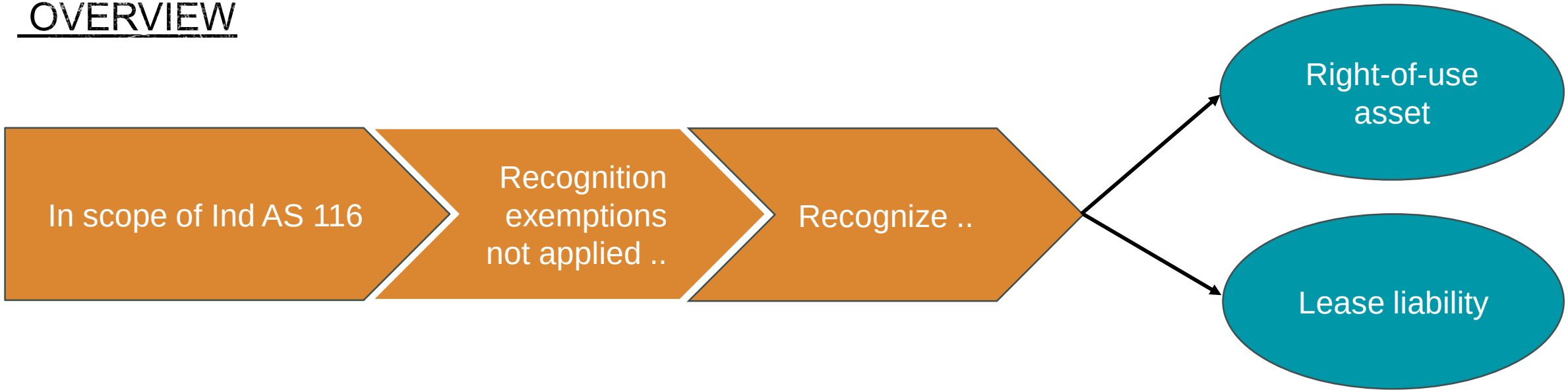


The lease term begins at the commencement date
(i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods provided to the lessee by the lessor.

Accounting by Lessee

RECOGNITION AND MEASUREMENT

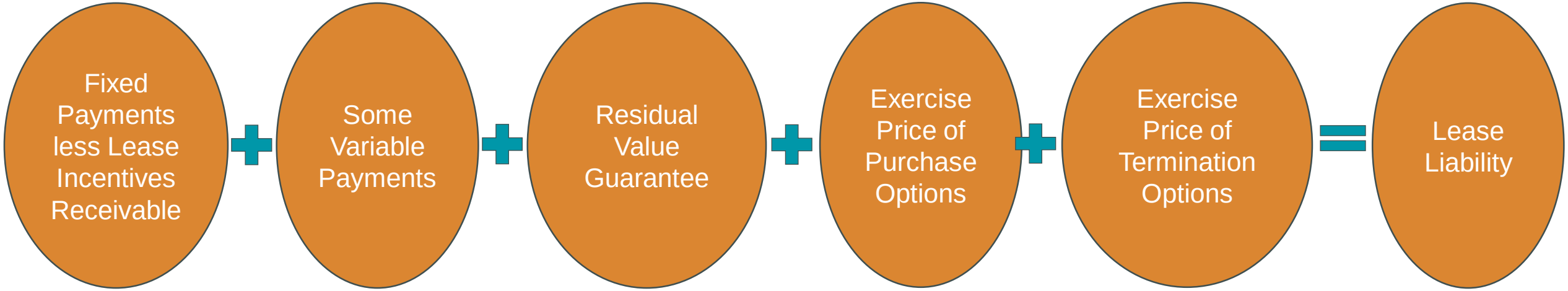
OVERVIEW



Recognition and measurement

LEASE LIABILITY

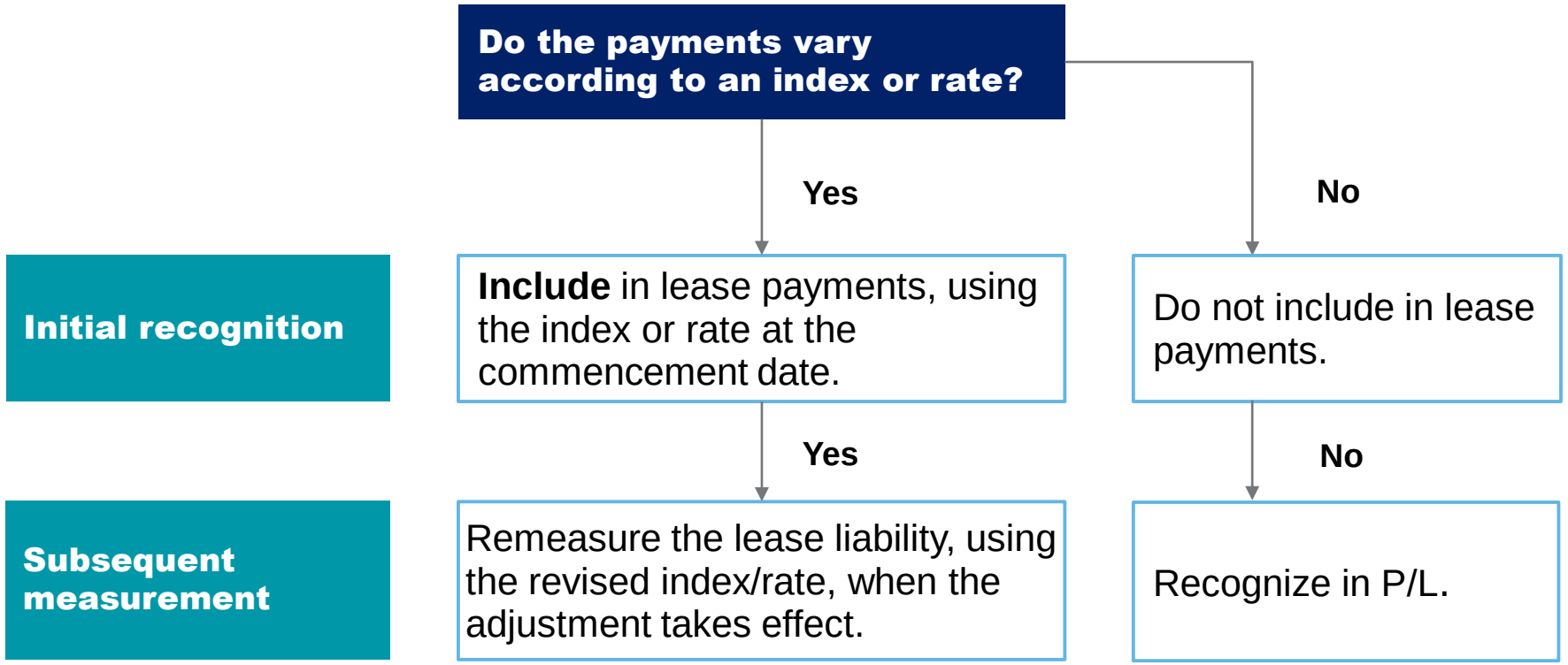
- Measurement of the lease liability consists of the present value of the following components that **have not been paid** at the **commencement date**:



Variable lease payments

DEFINITION

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



Variable lease payments

Example: Market-Fresh

A new lease contract

Market-Fresh enters into a 10 year lease of a building, to be used as its head office.

- **Annual rent payments are $100,000, payable annually in advance, but will increase every two years on the basis of the increase in CPI for the preceding two years.**
- **CPI at the commencement date is 125 and at the end of Year 2 is 135.**

How is the lease liability accounted for?

Reporting period	Lease liability
At commencement date	PV of $100K received annually for 10 years
At the end of Year 1	Decreases by $100K Increases by annual interest
At the end of Year 2	Decreases by $100K Increases by annual interest
Beginning of Year 3	The lease payments are remeasured as $100K * 135 / 125 = $108K PV of $108K received annually over the remaining lease term



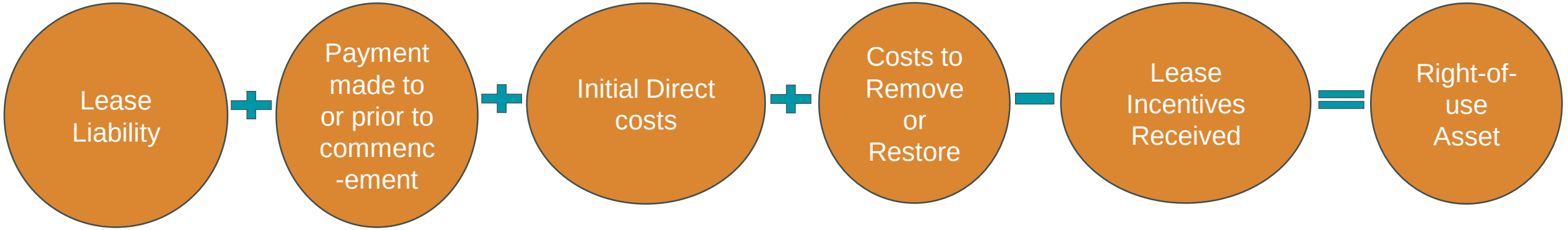
Recognition and measurement

DISCOUNT RATE

- Interest rate implicit in the lease should be used unless it is not readily determinable.
- Implicit rate is often difficult to determine in practice, therefore, incremental rate of borrowing may be used
  - Similar security to right-of-use asset
  - Borrowing of similar term to lease term
  - Same currency as the lease payments
- Inappropriate to use WACC

RIGHT-OF-USE-ASSET

- Right-of-use asset on initial recognition is measured at cost, comprising:



Revise the discount rate

The discount rate is revised as a result of remeasurement of the lease liability if:

- ✓ There is a change in the lease term **OR**
- ✓ There is a change in the assessment of an option to purchase the underlying asset.

If readily determined…

Use the **interest rate implicit in the lease** for the remainder of the lease term.

If **not** readily determined…

Use the lessee's **incremental borrowing rate** at the date of reassessment.

Recognition and measurement

CALCULATING LEASE LIABILITY AND ROU ASSET

Example

Entity ‘XYZ’ (the lessee) enters into a 5-year lease of a floor of a building, with a 5 year extension option. Lease payments are INR 50,000 per annum (including the extension period) all payable at the beginning of each year. To obtain the lease, lessee incurs initial direct costs of INR 20,000 (INR 15,000 paid to the former tenant occupying the floor and INR 5,000 for real estate commissions).

The terms of the lease also require Entity ‘XYZ’ to pay the lessor 2% of the gross sales revenue generated from the space being rented.

Entity Z concludes that it is reasonably certain that it will exercise the extension option.

The rate implicit in the lease is not readily determinable. The lessee has determined that its incremental rate of borrowings is estimated at 5% per annum.

Recognition and measurement

EXAMPLE - LEASE LIABILITY

Fixed Payments less Lease Incentives Receivable	+	Some Variable Payments	+	Residual Value Guarantee	+	Exercise Price of Purchase Options	+	Exercise Price of Termination Options	=	Lease Liability
355,391 Less Nil	+	Nil	+	Nil	+	Nil	+	Nil	=	355,391
9 payments of INR 50,000 discounted at 5%		Exclude variable payments that do not depend on a rate index		N/A		N/A		N/A		

Recognition and measurement

SOLUTION

- To record the initial value of the lease asset and liability:

Dr	Right-0f-use asset	4,25,391[1]	
Cr	Lease liability		3,55,391[2]
Cr	Cash		70000[3]

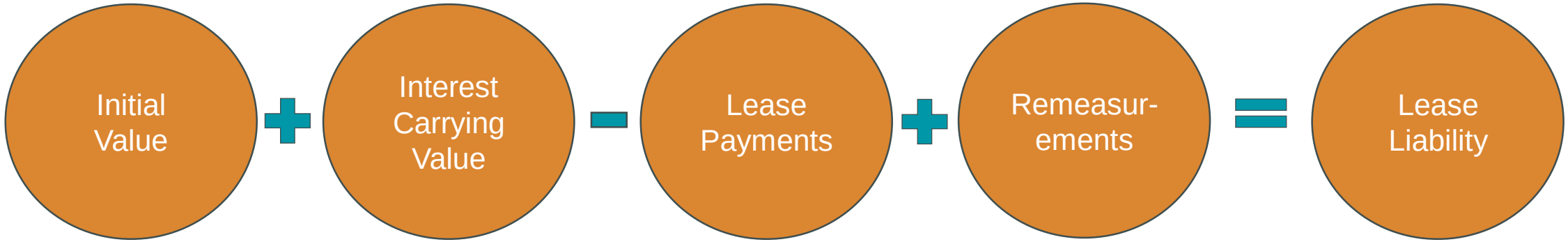
1. PV of 9 payments at INR 50,000, discounted at 5%+INR 50,000 (initial payment made up front) +INR 20,000 initial direct costs
2. PV of 9 payments at INR 50,000 , discounted at 5%
3. INR 50,000 first period rent + INR 20,000 direct cost

Subsequent measurement and re-measurement of lease liabilities and right-of-use assets

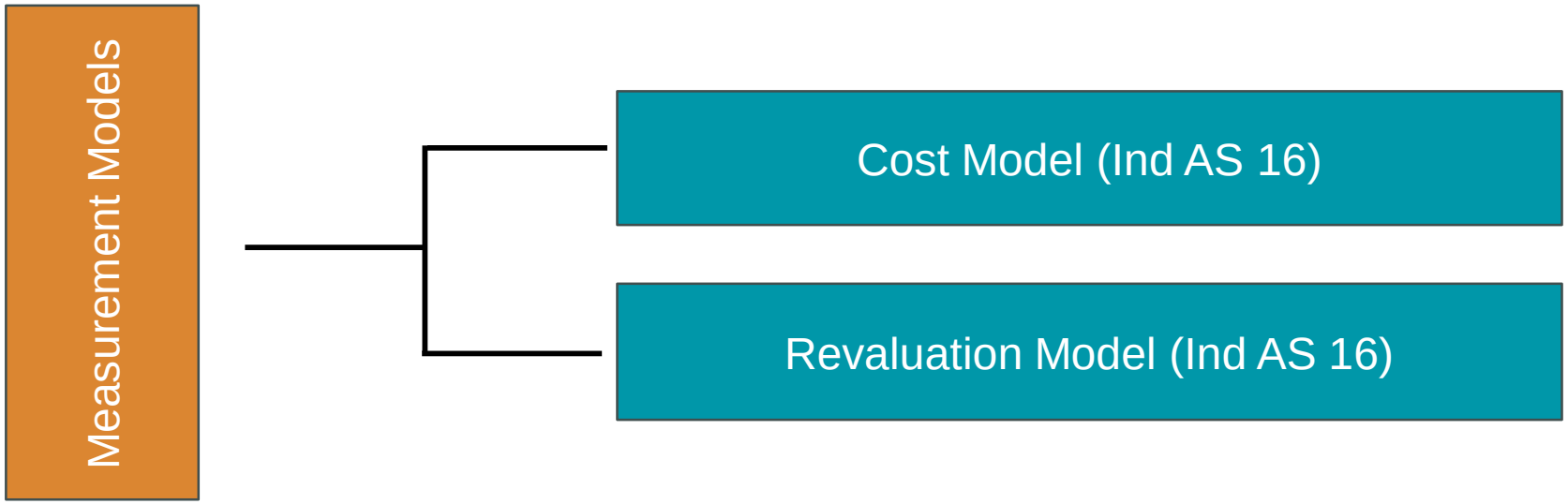
Subsequent measurement

LEASE LIABILITY

- Subsequent accounting is similar to other interest-bearing liabilities, except for more specific guidance on remeasurements.



RIGHT-OF-USE ASSET



Lease modifications

Lease modifications

SEPARATE LEASE

Does the modification give rise to a separate lease?

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

+

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

Assessed using the criteria to determine whether a contract is, or contains, a lease(e.g. identified asset, obtain economic benefit, right to direct use



Presentation - lessee

INITIAL RECOGNITION - FINANCIAL STATEMENTS

Balance Sheet	Statement of Profit / Loss	Cash Flow
• Right-of-use asset: Present in its own line item separately from other assets with separate disclosure. • If ROU assets meet the definition of investment property, it shall be presented in the balance sheet as investment property • Lease liabilities : present separately from other liabilities	• Interest expense with other finance costs • Amortization of right-of-use assets	• Cash payments for lease liabilities as financing activities • Cash payments for interest in accordance with Ind AS 7's requirement for interest paid • Short-term, low-value and variable lease payments within operating activities.



Disclosure – lessee

SUBSEQUENT RECOGNITION - FINANCIAL STATEMENTS

Balance Sheet

- Additions to right-of-use assets.
- Carrying value of ROU assets at the end of the reporting period by class.
- Maturity analysis of lease liabilities separately from other liabilities based on Ind AS 107 requirement.

Statement of Profit / Loss

- Depreciation for assets by class.
- Interest expense on lease liabilities.
- Short-term leases expensed*.
- Low value leases expensed
- Variable lease payments expensed.
- Income from subleasing.
- Gains or losses arising from sale and leaseback transactions.

Cash Flow

- Cash payments for lease liabilities as financing activities.
- Cash payments for interest in accordance with Ind AS 7's requirement for interest paid.
- Short-term, low-value and variable lease payments within operating activities.

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



Disclosure – lessee

Qualitative Disclosure Requirements*

• A summary of the nature of the entity's leasing activities;
• Potential cash outflow the entity is exposed to that are not included in the lease liability, including:
  • Variable lease payments;
  • Extension options and termination options;
  • Residual value guarantees; and
  • Leases not yet commenced to which the lessee is committed.
  • Restrictions or covenants imposed by leases; and
  • Information about sale and leaseback transactions

* The above disclosures include the major disclosure requirements. Additional disclosures might be required based on particular facts and circumstances of each case.

Disclosure – lessor

Qualitative Disclosure Requirements*

• A summary of the nature of the entity's leasing activities;
• This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:
  • Buy-back agreements;
  • Residual value guarantees;
  • Variable lease payments for excess use; and
  • Any other risk management strategies

* The above disclosures include the major disclosure requirements. Additional disclosures might be required based on particular facts and circumstances of each case

THANK YOU

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