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CHARTERED ACCOUNTANTS

Transforming the way of Accounting for Leases – Ind AS 116

The Ministry of Corporate Affairs (MCA) has put an announcement that the new lease accounting standard, Ind AS 116 will get implemented from 1st April 2019. The new Standard, globally implemented in several countries from 1st Jan 2019, is called IFRS 16. The Standard eliminates the 6-decade old distinction between financial and operating leases, from lessee accounting perspective, thereby putting all leases on the balance sheet. Ind AS 116 introduces a single lease accounting model and requires a lessee to ***recognize assets and liabilities for all leases with a term of more than 12 months***, unless the underlying asset is of low value.

Assessment of whether an arrangement is, or contains, a lease, will be one of the biggest practical issues when applying the new standard. Under the new standard, a lease is a contract, or part of a contract, that conveys the right to use an asset (underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset, which could be physically distinct portion of an asset such a floor of a building. A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to obtain substantially all of the economic benefit from the use of the identified asset and direct the use of identified asset.

Some of the key takeaways from the implementation of this Standard are:

- Currently, there are two accounting standards for lease transactions, first, Ind AS 17, which is applicable to the Ind AS compliant companies and second, AS 19, which is applicable to the remaining classes of companies. Ind AS 116 proposes to replace Ind AS 17, therefore, the companies which are not covered by Ind AS shall continue to follow old accounting standard.

- The applicability of this standard shall have to be examined separately for the lessor and the lessee, that is, if the lessor is Ind AS compliant and lessee is not Ind AS compliant, then lessor will follow Ind AS 116 whereas lessee will follow AS 19.

- The key changes in lessee's accounting relate to introduction of single lease accounting model by elimination of classification between operating and finance leases, and recognition of gain/ loss for sale and lease-back transactions. The new standard changes treatment of operating leases in the books of the lessees significantly. Earlier, operating leases remained completely off the balance sheet of the lessee, however, vide this standard, lessees will have to recognise a right-to-use asset on their balance sheet and correspondingly a lease liability will be created in the liability side.

- No change in the accounting treatment in case of financial leases.
- No change in the lessor's' accounting

- For aircraft and other assets taken on an operating lease, the airline company will recognise right to use asset together with a lease liability on the balance sheet.

- Foreign currency leases shall increase profit & loss volatility due to a restatement of foreign currency liability.

Accounting by Lessee:

- Lessees are required to initially recognise a lease liability for the obligation to make lease payments and a right to use asset for the right to use the underlying asset for the lease term.

- Lease liability is initially recognised and measured at an amount equal to the present value (PV) of minimum lease payments during the lease term that are not yet paid.

- Right of use of asset is recognised and measured at cost, consisting of initial measurement of lease liability plus any lease payments made to the lessor at or before the commencement date less any lease incentive received, initial estimate of the restoration, removal and dismantling costs.

- The Lease liability is measured in subsequent periods using the effective interest rate method. The right of use of asset is depreciated in accordance with the requirements in IND AS 16, Plat Property & Equipment.

- Recognition and measurement exemption are available for low value assets and short-term leases. Assets of low value include Information Technology equipment or office furniture. No monetary threshold has been defined for low value assets. Short term leases are defined as leases with a lease term of 12 month or less.

Accounting by Lessor:

- The accounting by lessor under the new standard is substantially unchanged from today's accounting in IND AS 17. Lessor classify all leases using the same classification principle as in IAS 17 and distinguish between two type of leases.

- For Operating leases, lessor continue to recognise the underlying asset. For finance lease, Lessor derecognise the underlying asset and recognise a net investment in the lease similar to today's requirements. Any selling profit or loss is recognised at lease commencement.

Sales and leaseback transactions:

- Ind AS 116 contains specific guidance on accounting of a sale and lease back transaction. In a sale and lease back transaction, an entity (the Seller – Lessee) transfers an underlying asset to another entity (the buyer – lessor) and leases that assets back from the buyer – lessor.

- A seller lessee and a buyer lessor use the definition of a sale form Ind AS 115 to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirement of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, transaction will be accounted for as a financing by both the seller lessee and buyer lessor.

Impact on the financial statement of the lessee :

I. **Statement of financial position:**

Recognition of right of use asset and corresponding lease liability result in increase in the amount recognised for financial liabilities and assets for entities that has material operating lease.

New Accounting requirements for lessees will impact debt equity ratios and may also cause entities to breach existing debt covenants.

II. **Statement of comprehensive income:**

De recognition of operating lease charges and recognition of depreciation and finance costs would positively impact EBIT & EBITDA.

Recognition of depreciation on right of use assets and unwinding of finance costs on lease liabilities results in higher costs being recognised during the beginning of the lease term.

III. **Statement of cash flows:**

Presentation of lease payments as cash flow from financing activities has a favourable impact on cash flow from operations.

Disclosure requirements :

Ind AS 116 requires enhanced quantitative and qualitative disclosures for both lessors and lessees.

Quantitative Information:

Balance sheet

- Additions to the right of use assets
- Carrying amount of right of use assets at the end of the reporting period by class of underlying asset
- Lease liabilities
- Maturity analysis for lease liabilities

Statement of Profit and Loss and Other Comprehensive Income

- Depreciation charge for right of use assets by class of underlying asset
- Interest expense on lease liabilities
- Expense relating to short term leases for which the recognition exemption applied
- Expense relating to variable lease payments not included in measurement of lease liabilities
- Gain or losses arising from sale and leaseback transactions.

Qualitative disclosure

- Description of how liquidity risk related to lease liabilities is managed
- Use of exemption for short term and low value item leases
- Nature of the lessees leasing activities
- Restrictions or covenants imposed by leases and
- Sale and leaseback transactions

Conclusion

Ind AS 116 sets out principles for recognition, presentation and disclosure of leases. The new accounting norms have been notified by the MCA. The key change that has been introduced is the elimination of classification between operating and finance leases, which means that all leases on a lessee's balance sheet will be recognised. The balance sheet of asset-light companies will expand sharply as a result, most aviation companies acquire aircraft via lease while retail and multiplex companies in the organized space operate mainly from leased premises. Healthcare sector companies such as hospitals and diagnostic service providers acquire equipments on lease. Similarly, hotels acquire immovable properties and vehicles on operating lease. Telecom companies will have to recognize agreements for sharing passive infrastructure in balance sheet, which were till not kept off balance sheet.