CHAPTER 2

Ind AS 116, *Leases*: Emerging implementation challenges

This article aims to:

Discuss key implementation issues of the new standard on leases - Ind AS 116 with the help of practical examples.

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The new standard on leases, Ind AS 116, *Leases* is effective for companies from 1 April 2019. Ind AS 116 eliminates the classification of leases as either finance or operating lease as required by Ind AS 17, *Leases*. Ind AS 116 introduces a single on-balance sheet accounting model that is similar to current finance lease accounting model. Therefore, a company is expected to report majority of its operating leases on-balance sheet as if the company has borrowed funds to purchase an interest in the leased asset (i.e. it would be recognising a right-of-use asset and a corresponding lease liability in its balance sheet). Apart from the balance sheet, statement of profit and loss of a company would also undergo a change as operating lease expenses will be bifurcated into depreciation on the right-of-use asset and interest expense on the lease liability.

Implementation of the new standard is likely to pose many practical challenges for companies which extend beyond general and financial reporting including areas such as legal, treasury, internal audit, taxation, budgeting, regulatory, etc.

In this article, we aim to discuss some of the key challenges faced by the companies while implementing the requirements of Ind AS 116 with the help of practical examples.

Common transition approaches

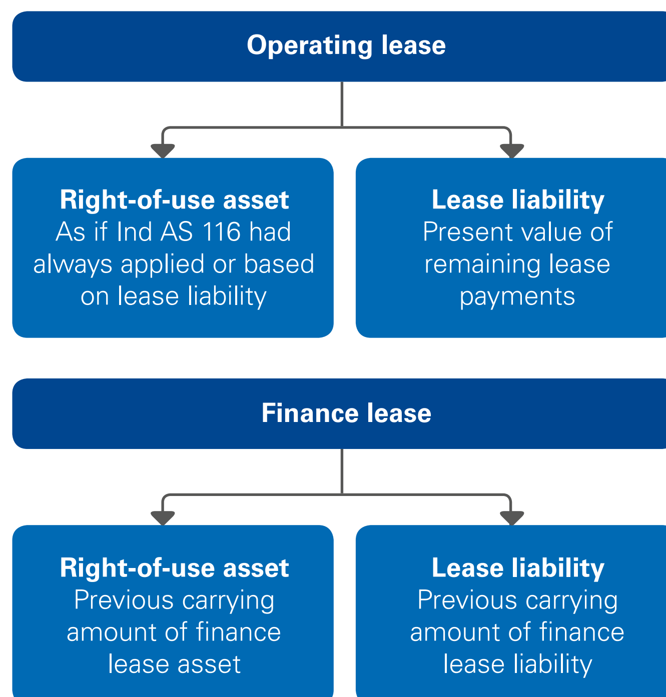
Ind AS 116 provides two optional approaches to transition. They are as follows:

a. **Full retrospective approach:** Under this approach, the lessee applies the new standard retrospectively in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. For this purpose, the lessee applies the standard retrospectively to each prior period presented and recognises an adjustment in equity at the beginning of the earliest period presented.

b. **Modified retrospective approach:** Under this approach, a lessee applies the new standard from the beginning of the current period. For this purpose, the lessee calculates lease assets and lease liabilities as at the beginning of the current period and recognises an adjustment in equity at the beginning of the current period. Accordingly, a lessee will not restate its prior period financial information under this approach.

A lessee is required to apply the election (out of the two approaches) consistently to all of its leases in which it is a lessee.

A modified retrospective approach would be applied as follows:



Measurement of right-of-use asset - Practical expedient for leases previously classified as operating leases

Under modified retrospective approach, for leases previously classified as operating leases, a lessee is permitted to choose either of the following options to measure the right-of-use asset at the date of initial application:

- **Option 1:** At its carrying amount as if the standard had been applied since the commencement date but discounted using the lessee's incremental borrowing rate at the date of initial application.
- **Option 2:** At an amount equal to lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the balance sheet immediately before the date of initial application.

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Issue: Whether the above options are available on a lease-by-lease basis or to a company as a whole?

Ind AS 116 specifies that the options under modified retrospective approach are available to a company on a lease-by-lease basis. This allows companies to make their own trade-off between cost and comparability when designing their transition approach. In case relevant information is available to compute the incremental borrowing rate at the date of initial application, then companies can opt option 1 (i.e. calculate right-of-use asset at its carrying amount as if Ind AS 116 had always been applied).

In practice, we have observed that option 1 is being opted by companies. The initial carrying amount under option 1 will be lower than option 2. This is because option 1 depicts the right-of-use asset amortisation profile (depreciated on a straight-line basis) whereas option 2 depicts the lease liability amortisation profile (measured using the effective interest method). Also, depreciation charge under option 1 will be lower as compared to option 2.

This is explained with the help of an example.

Example: A retailer J, enters into a lease for a retail store for a fixed rent of INR100 per annum paid at the end of each year. The lease commences on 1 April 2014 when J's incremental borrowing rate is 7 per cent. The non-cancellable period of the lease is 10 years, renewable for a further five years.

Under Ind AS 17, J classifies the lease as an operating lease and recognises the lease payments as an expense on a straight-line basis.

J adopts the new standard following modified retrospective approach with a date of initial application being 1 April 2019. At that date:

a. J is not reasonably certain to exercise renewal option. Therefore, the remaining term of the lease is five years.

b. J's incremental borrowing rate is 5 per cent.

Given the facts of the case, J will be required to measure lease liability as at 1 April 2019 based on the lease payments over the remaining lease term (five years at INR100 per annum) discounted at its incremental borrowing rate at that date i.e. 5 per cent - giving a lease liability of INR433.

J may calculate the carrying amount of the right-of-use asset in either of the following manner:

Option 1: *Retrospective but using the incremental borrowing rate at 1 April 2019:* Measure right-of-use asset at the present value of the lease payments over the 10 year term (10 years at INR100 per annum) discounted at J's incremental borrowing rate on transition i.e. 5 per cent - giving an amount of INR772.

Considering that J choses to depreciate right-of-use asset on a straight-line basis over the lease term, the carrying amount of the right-of-use asset on transition date is 5/10 x INR772 = INR386.

The balance amount of INR47 (i.e. INR433-INR386) will be debited to retained earnings.

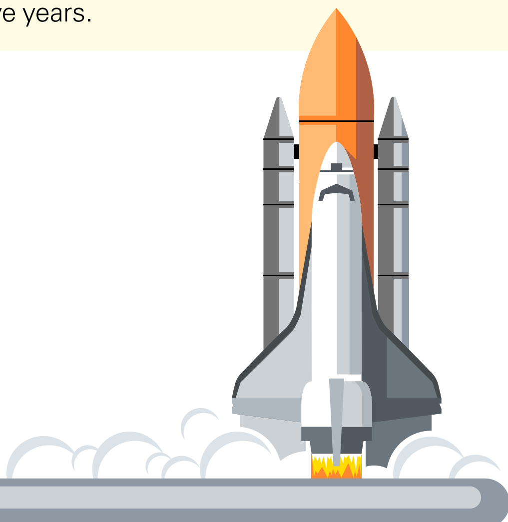
Option 2: *Equal to lease liability:* Measure the right-of-use asset at an amount equal to lease liability i.e. INR433.

The initial carrying amount under option 1 is lower than option 2. Accordingly, the depreciation charge computed under option 1 is lower than depreciation charge as per option 2:

Option 1: 1/5 x INR386 = INR77

Option 2: 1/5 x INR433 = INR87.

(Source: KPMG IFRG Ltd.'s publication 'Leases transition options - What is the best option for your business? November 2018)



Deferred tax implications

Currently, for operating leases, a lessee generally records a Deferred Tax Asset (DTA) for the accrued rent liability that exists, which equals the difference between the cumulative rent deductible for income tax purposes (sometimes based on the cash paid) and the cumulative rent recognised for book purposes (generally on a straight line basis). Since a lessee does not recognise any underlying asset or any right-of-use asset for book purposes, the only temporary difference created is the difference between the rent expense recognised for tax purposes and book purposes.

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Issue: Whether deferred taxes would be required to be computed with respect to right-of-use asset and lease liability on transition to Ind AS 116 when an entity applies modified retrospective approach and measures right-of-use asset at its carrying amount and discounted using incremental borrowing rate at the date of initial application? If yes, then where such deferred taxes should be accounted?

On initial application of Ind AS 116, a lessee that applies modified retrospective approach and measures right-of-use asset at its carrying amount and discounted using incremental borrowing rate at the date of initial application and a lease liability would recognise any deferred tax impact in retained earnings.

However, the tax base of the right-of-use asset would be nil because there are no associated tax deductions from recovering the asset. The lease liability's tax base would also be nil because the lease payments would be deductible in future.

As a result, the lease would give rise to two separate temporary differences:

- A temporary difference related to right-of-use asset and
- A temporary difference related to the lease liability.

The asset and liability that arise for accounting purposes under a lease are integrally linked. Accordingly, they should be regarded as a net package for the purpose of recognising deferred tax.

Example: Company A transitions to Ind AS 116 with effect from 1 April 2019, using the modified retrospective method. It measures the right-of-use asset based on option 1 i.e. as though Ind AS 116 was always applied. Based on the given approach, company A records a right-of-use asset of INR5,000 million and a lease liability of INR6,000 million.

Further, in the jurisdiction in which company A operates, expenses are allowed as a deduction from taxable income for tax purposes based on actual payments i.e. depreciation of the right-of-use asset and interest expense on the lease liability are not considered to be allowable expenses. There is a timing difference in terms of the accounting profit and the taxable profit.

In the given case, company A would be required to recognise deferred tax (DTA or Deferred Tax Liability (DTL)) to the extent of difference between the right-of-use asset and lease liability i.e. INR1,000 million (INR6,000-INR5,000 million). Such deferred taxes would be initially recorded through retained earnings on transition and thereafter through the statement of profit and loss.

Rent equalisation/deferred rent

Under Ind AS 17, lease payment under an operating lease is recognised as an expense on a straight-line basis over the lease term. This straight-lining of rent expense may result in recognition of a rent equalisation reserve or an asset (prepaid/deferred rent) in the balance sheet.

Issue: What would be the treatment of such rent equalisation liability and/or deferred rent on transition to Ind AS 116?

A lessee that opts for modified retrospective approach to transition would have two options.

Option 1: To recognise right-of-use asset at the date of initial application at an amount equal to lease liability. In this case, the rent equalisation liability would be regarded as 'accrued lease payments' and the amount of right-of-use asset would be determined by deducting the said liability from the amount of 'lease liability'.

Option 2: To compute the right-of-use asset at its carrying amount as if the standard has always been applied but discounted using the lessee's incremental borrowing rate at the date of initial application. In this case, it would recognise in retained earnings (or other component of equity), the difference, as at the date of initial application of Ind AS 116 (i.e. 1 April 2019), between:

a. The amount at which right of use asset is measured, together with the amount of rent equalisation liability, and
b. The amount at which lease liability is measured.

This could be explained with the help of an example.

Example: Company A transitions to Ind AS 116 with effect from 1 April 2019. For periods up to 31 March 2019, company A has recognised rental expenses under operating lease arrangements on a straight-line basis and recorded a rent equalisation reserve of INR10 million.

In the given case, if company A opts for modified retrospective approach to transition to Ind AS 116 and has elected to compute right-of-use asset:

a. At an amount equal to lease liability: Company A should adjust the amount of lease equalisation reserve (INR10 million) from the right-of-use asset. There will be no impact in retained earnings in the given option.
b. At its carrying amount discounted using incremental borrowing rate at the date of initial application: Company A should adjust the amount of lease equalisation reserve (INR10 million) from retained earnings from the right-of-use asset.

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Continuing with the above example, company A, in line with the requirements of Ind AS 109, Financial Instruments, had discounted the security deposits given to lessors and accounted for the difference between cash outflows and present value of security deposits, as deferred rent. As at 31 March 2019, company A carried a deferred rent of INR15 million in its balance sheet.

As per the requirements of Ind AS 116, the deferred rent (INR15 million) would be adjusted from the right-of-use asset.

Recognition exemption - Low value assets

Under Ind AS 116, a lessee may elect not to apply lessee accounting model to leases for which the underlying asset is of low value. The election for leases of low-value assets can be made on a lease-by-lease basis.

An underlying asset can be of low value only if:

a. The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee and

b. The underlying asset is not highly dependent on, or highly interrelated with, other assets.

Issue: Whether any quantitative threshold has been prescribed under Ind AS 116 below which assets could be qualified as low value assets?

Ind AS 116 do not specify any threshold for the low-value exemption to exclude assets from lease accounting. However, it provides that a lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

The standard provide examples of certain assets which can be considered as low value assets such as tablet and personal computers, small items of office furniture and telephones.

Another area of concern for availing low value lease exemption relates to whether the asset need to be of low value on the date of transition to Ind AS 116 or on the initial date when the lease arrangement was entered into.

The standard clearly states that a lessee should assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased. The assessment of whether an underlying asset is of low value is performed on an absolute basis.

Additionally, leases of low-value assets qualify for exemption under the new standard regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.

Conclusion

Implementation of the new standard on leases involves significant judgements and critical assessment of the terms of a given lease arrangement. Companies should carefully evaluate the implications of the change in accounting envisaged by Ind AS 116 and ensure that they are equipped with systems and processes to cater such challenges.

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