New standard on leases notified

2 April 2019

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Introduction

On 30 March 2019, the Ministry of Corporate Affairs (MCA) notified Indian Accounting Standards (Ind AS) 116, *Leases* as part of the Companies (Ind AS) Amendment Rules, 2019. Ind AS 116 replaces existing standard on leases i.e. Ind AS 17, *Leases* with effect from accounting periods beginning on or after 1 April 2019.

Ind AS 116 is largely converged with International Financial Reporting Standard (IFRS) 16, *Leases*.

In this issue of First Notes, we aim to provide an overview of the key requirements of Ind AS 116.

Overview of Ind AS 116

The core objective of the standard is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information is likely to provide a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the entity.

Lessees to face major changes

Lessor accounting remains unchanged

Major impact on balance sheet and statement of profit and loss

The new standard has major impact for lessees. It eliminates the classification of leases as either finance leases or operating leases as required by Ind AS 17. It introduces a single on-balance sheet accounting model that is similar to current finance lease accounting model. Therefore, majority of operating leases will be on-balance sheet as if the entity has borrowed funds to purchase an interest in the leased asset.

A lessee would be required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

Overview of Ind AS 116 (cont.)

Impact on the balance sheet and the statement of profit and loss is depicted below:

Balance sheet

Asset
= 'Right-of-use' of underlying asset

Liability
= Obligation to make lease payments

Profit/loss

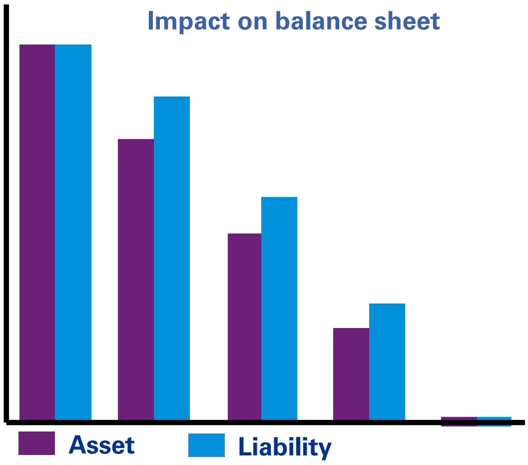
Lease expense

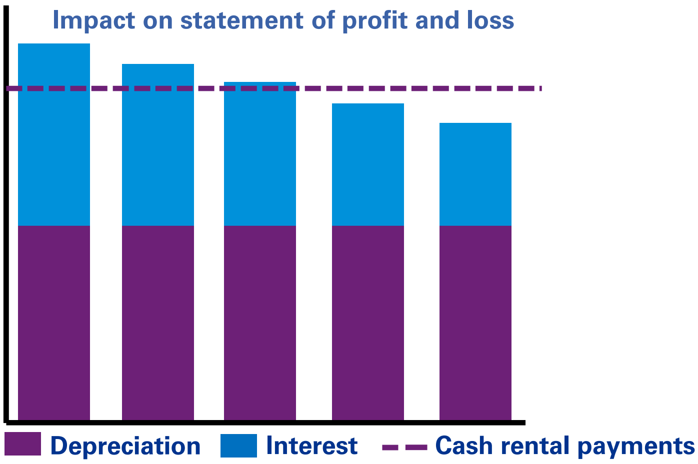
Depreciation + Interest

= Front-loaded total lease expense

Balance sheet of the lessee would be significantly grossed up i.e. companies with operating leases will appear to be more asset-rich, but also more heavily indebted.

Total lease expense in the statement of profit and loss would be front-loaded though cash rentals would remain constant over the period of the lease.

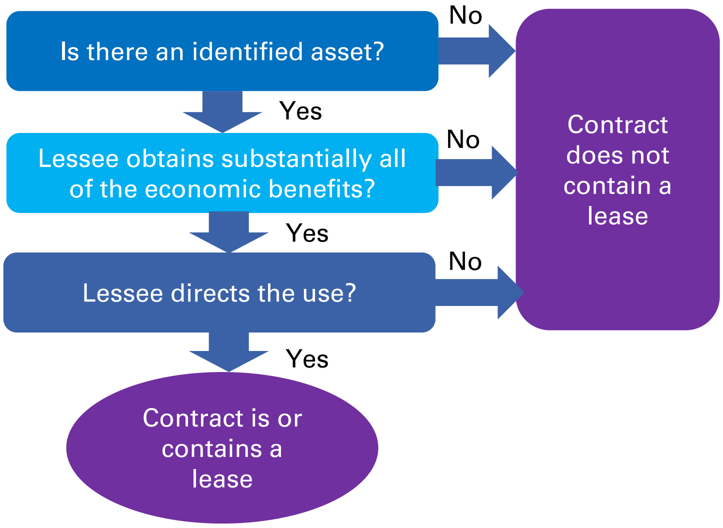




Lease definition is the new on/off balance sheet test

A lessee is required to assess, at the inception of a contract, whether the contract contains a lease. As per Ind AS 116, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration.

Accordingly, the key elements of the definition of lease to be considered are as follows:



(Source: KPMG IFRG publication 'First Impressions: IFRS 16, *Leases*', January 2016)

Overview of Ind AS 116 (cont.)

A lessee would need to consider following aspects of the lease:

- Is there an identified asset?
- Does the lessor have *substantive* substitution rights?
- Would lessee obtain substantially all of the economic benefits from use of the asset?
- Who has the right to direct the use of the asset i.e. who takes the *'how and for what purpose'* decisions?

Lease definition – Exemptions

A lessee may elect not to apply the lessee accounting model to:

Leases with a lease term of 12 months or less that do not contain a purchase option i.e. short term leases

Leases for which the underlying asset is of low value when it is new – even if the effect is material in aggregate.

Lease and non-lease components

If a contract is, or contains, a lease, then the entity is required to account for each lease component within the contract as lease separately from non-lease components of the contract.

A lessee considers the right to use an underlying asset as a separate lease component if it meets both the following crtieria:

Separate lease component = Lessee benefits from the use of underlying asset on its own or together with other resources that are readily available + Asset is neither highly dependent on, nor highly inter-related with, the other underlying assets in the contract

Accounting by lessor

A lessor would classify its leases as operating leases or finance leases.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

The lease classification test is based on Ind AS 17 classification criteria.

Also, unlike Ind AS 17, Ind AS 116 does not include any exemption from recognising income on a straight-line basis over the lease term in relation to general inflation.

Effective date and transition options

Ind AS 116 has been made effective for annual periods beginning on or after 1 April 2019.

Lease definition

On transition, the new standard permits a company to:

a) Apply the new definition of lease to contracts that were previously identified as leases (as per Ind AS 17)

b) Not to apply the definition to the contracts that were not previously identified as containing a lease (as per Ind AS 17).

A lessee is permitted to:

a) Adopt the standard retrospectively following Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* or

b) Follow a modified retrospective approach i.e. to apply the standard retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application.

A lessee is required to apply the election consistently to all of its leases.

Overview of Ind AS 116 (cont.)

Approach	31 March 2019	31 March 2020	Date of equity adjustment
Full retrospective (no practical expedients)	Ind AS 116* / Ind AS 17*	Ind AS 116	1 April 2018
Modified retrospective (with practical expedients)	Ind AS 17	Ind AS 116	1 April 2019

*(*The company will apply Ind AS 17 in preparing its financial statements for year 31 March 2019. It will then apply Ind AS 116 to prepare comparative financial information to be included in its FY2019-20 financial statements)*

(Source: KPMG In India's analysis, 2019)

Differences from IFRS 16

- Ind AS 116 does not allow application of fair value model to the right-of-use assets that meet the definition of an investment property.
- As per Ind AS 116, cash payments for interest portion of lease liability will always be classified as financing activities in the statement of cash flows and not operating activities.

Key differences from Ind AS 17

- Single lessee accounting model - lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.
- Lessee to recognise depreciation expense on the right-of-use asset and interest expense on the lease liability.
- Specific guidance provided on lease modification for lessor and lessee.
- Additional disclosure requirements for lessors and detailed disclosure requirements for lessees.

Our comments

The notification of Ind AS 116 is a welcome step as it aligns the applicability date with that of the global standard on leases i.e. IFRS 16.

The new standard is expected to bring more transparency and comparability as compared to the current requirements. Companies with major assets on lease will have to report more assets and liabilities on their balance sheets which is expected to affect most of the sectors in particular, airlines and real estate.

The impact will also extend to the statement of profit and loss which will show front-loaded expense pattern for most leases even though the rentals would remain constant.

The other key impacts are as follows:

- **Identification of lease agreements and extraction of lease data:** As lessee is required to present most of the leases on the balance sheet, substantial efforts would be required to identify all lease arrangements and extract all relevant lease data necessary to apply the standard.
- **Changes in key financial metrics:** With additional reporting of assets and liabilities, key financial metrics such as Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA), asset turnover ratio, interest coverage ratio, etc., would get affected.
- **Changes in contract terms and business practices:** The application of new standard may require companies to reconsider their contract terms and business practices such as changes in the restructuring/pricing of a

Our comments (cont.)

transaction including lease length and renewal options. Therefore, the standard is most likely to affect departments other than financial reporting such as legal, tax, sales, budgeting, IT, etc.

- **New systems and processes:** Ind AS 116 is expected to necessitate changes in the systems of companies so as to capture data required for application of it, such as creating inventory of all leases on transition.
- **Transition considerations:** Ind AS 116 provides certain transition options along with practical expedients to choose from. Companies would need to analyse which of them would be most beneficial in terms of cost and implementation efforts.
- **Impact on sectors**: Ind AS 116 is expected to affect the accounting of leases in various sectors. The key sectors to be impacted are property leases, transport, logistics and leisure, automotive, telecom, media and entertainment and consumer and retail market.
- **Disclosure of impact on financial statements:** Ind AS 8 requires an entity to disclose the likely impact of a standard that has been issued but is not yet effective on the entity's financial statements in the period of initial application. Ind AS 116 has been notified on 30 March 2019, therefore, entities would be required to disclose the possible impact of the standard in the financial statements for the period ended 31 March 2019.

Next steps

With very less time in hand, companies should gear up for rapid transition to the new standard. Investors and other stakeholders would also want to gain an understanding of the impact of the new standard on the business, in particular, impact on financial results, cost of implementation and changes to the business practices, if any. Accordingly, companies should carefully evaluate such factors while implementing the standard to reduce some of the expected implementation challenges.

KPMG in India

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala,
Bengaluru – 560 071
Tel: +91 80 3980 6000

Chandigarh
SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh – 160 009
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road
Chetpet, Chennai – 600 031
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurugram, Haryana – 122 002
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City, 6th
Floor, Unit 3, Phase III, Sy No.
83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091
Tel: +91 33 4403 4000

Mumbai
1st Floor, Lodha Excelus,
Apollo Mills
N. M. Joshi Marg,
Mahalaxmi, Mumbai – 400 011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex, Mundhwa
Road, Ghorpadi, Pune – 411 001
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E, Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District ,
Andhra Pradesh - 520008
Contact: 0866-6691000

KPMG in India’s IFRS institute

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The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

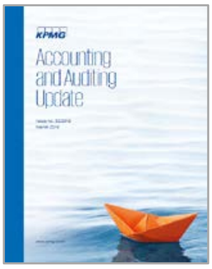
RBI defers implementation of Ind AS for banks till further notice

26 March 2019

Scheduled Commercial Banks (SCBs) excluding Regional Rural Banks (RRBs) were initially required to implement Indian Accounting Standards (Ind AS) from 1 April 2018. However, RBI vide a press release dated 5 April 2018, deferred the implementation of Ind AS by one year i.e. 2019-20 would have been the first year of Ind AS with 2018-19 as the comparative year.

The RBI through a notification dated 22 March 2019, has further deferred the Ind AS implementation till further notice.

Missed an issue of Accounting and Auditing Update or First Notes



Issue no. 32 – March 2019

The topics covered in this issue are:

- Not for Profit Organisations - accounting, tax and regulatory requirements
- Accounting for transfer of debtors to franchisee
- Accounting for investments in an associate and joint venture
- Regulatory updates.

MCA further amends deposit norms - mandatory return for all amounts not considered as deposits

6 February 2019

On 22 January 2019, the Ministry of Corporate Affairs (MCA) through its notification issued the Companies (Acceptance of Deposits) Amendment Rules, 2019 which makes certain amendments to the Companies (Acceptance of Deposit) Rules, 2014 (Deposit Rules). The amendments have come into force from the date of their publication in the official gazette i.e. 22 January 2019.

This issue of First Notes provides a summary of the amendments made to the Deposit Rules.

Voices on Reporting

KPMG in India is pleased to present Voices on Reporting – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

A Voices on Reporting webinar is scheduled on 4 April 2019 to discuss the key financial reporting and regulatory matters relevant for the stakeholders for the quarter ended 31 March 2019.

Please click here for registration.

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