



# IFRS Notes

**ICAI issues exposure draft  
of Ind AS 116, *Leases***

28 July 2017

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## Background

The Ministry of Corporate Affairs (MCA) through a notification dated 16 February 2015 issued the Companies (Indian Accounting Standards) Rules, 2015 (Ind AS Rules) which laid down a road map for entities (other than insurance entities, banking entities and Non-Banking Financial Companies (NBFCs)) (corporate road map) for implementation of Ind AS converged with International Financial Reporting Standard (IFRS) in a phased manner. Accordingly, the MCA notified 40 Ind AS which included Ind AS 17, *Leases*.

Internationally, on 13 January 2016, the International Accounting Standards Board (IASB) issued IFRS 16, *Leases*. The new Standard represented a fundamental shift in accounting for leases, specifically for lessees. Additionally, it is expected to increase transparency and comparability of published financial information as analysts and investors would be able to see a company's own assessment of its lease liabilities, calculated using a prescribed methodology under Ind AS.

IFRS 16 is effective from 1 January 2019, with early application being permitted (as long as IFRS 15, *Revenue from Contracts with Customers* is also applied).

## New development

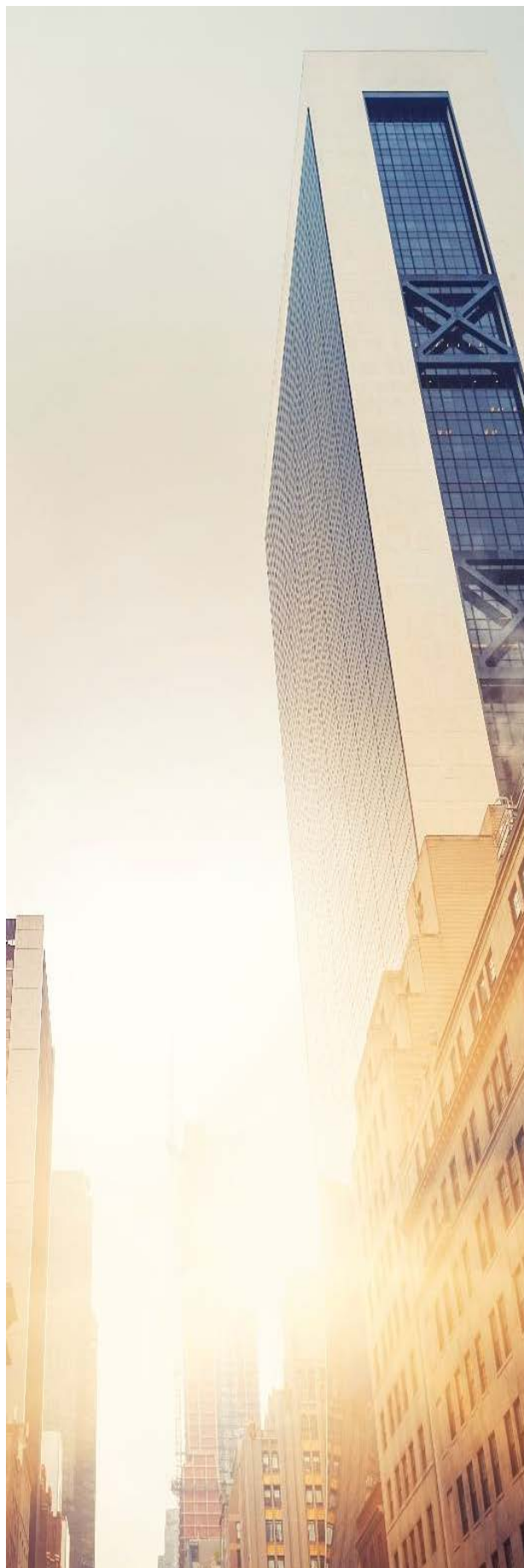
On 18 July 2017, the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft (ED) of Ind AS 116, *Leases*. Ind AS 116 is largely converged with IFRS 16.

Ind AS 116 is expected to replace Ind AS 17 from its proposed effective date, being annual periods beginning on or after 1 April 2019.

The ED sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective of the ED is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases will have on the financial position, financial performance and cash flows of the entity.

Comments on the ED may be submitted to ICAI by 31 August 2017.

This edition of IFRS Notes provides an overview of the key requirements of Ind AS 116 as proposed in the ED and highlights the key differences vis-à-vis IFRS 16.



## Overview of the ED on Ind AS 116

### Change in the definition of a lease

Ind AS 17 defined lease as 'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.'

However, as per the ED, lease is 'a contract or part of a contract that conveys the right to use an asset (the underlying asset\*) for a period of time in exchange for consideration'.

(\*An underlying asset has been defined to mean an asset that is the subject of lease, for which the right to use that asset has been provided by a lessor or lessee.)

The ED on Ind AS 116 provides additional guidance on the following aspects:

- **Identified asset and substitution rights:** A contract contains a lease only if it relates to an identified asset. While an asset may continue to be explicitly or implicitly specified in a contract, a lessee would not have control over the use of an identified asset if the lessor has a substantive right to substitute the asset throughout the period of use.

A lessor's substitution right is considered to be substantive if throughout the period of use, the lessor:

- Has the practical ability to substitute the asset, and
- Would benefit economically from exercising its right to substitute the asset.

Further, an entity's evaluation of whether a supplier's substitution right is substantive should be based on facts and circumstances at the inception of the contract and should exclude consideration of future events that, at inception of the contract, are not considered likely to occur.

- **Right to obtain economic benefits from use:** 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 in order to control the use of an identified asset. Such an economic benefit could be obtained from the use of an asset directly or indirectly, such as by using, holding or sub-leasing the asset.
- **Right to direct the use of an asset:** Similar to IFRS 16, under the proposed standard, a customer has the right to direct the use of an identified asset throughout the period of use only if meets any of the given criteria:
  - The customer has the right to direct how and for what purpose the asset is used throughout the period of use.

While 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 ED provides various examples of decision-making rights that grant/do not grant the right to change how and for what purpose the asset is being used.

- The relevant decisions about how and for what purpose the asset is used are predetermined and:
  - The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions, or
  - The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

### Accounting by lessee

The following changes have been made in the accounting by a lessee under the ED on Ind AS 116 as compared with Ind AS 17:

- The ED introduces a single lessee accounting model and requires a 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. 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. As a result there is likely to be an increase in reported assets and liabilities by lessees, with resultant impacts on key financial ratios and compliance with existing debt covenants.

Ind AS 17 requires classification of leases as finance lease and operating lease, with an operating lease not being recognised on the balance sheet by a lessee.

- Under the proposals in the ED, a lessee would be required to subsequently measure right-of-use assets similar to other non-financial assets (such as property, plant and equipment) and lease liabilities similar to other financial liabilities.

## Overview of the ED on Ind AS 116

As a consequence, a lessee would recognise depreciation expense on the right-of-use asset and interest expense on the lease liability, and also classify lease payments into a principal portion and an interest portion and present them in the statement of cash flows applying Ind AS 7, Statement of Cash Flows. This is expected to result in a front-loaded pattern of expenses for most leases despite constant rentals.

Under Ind AS 17, for operating leases, lessee is required to recognise the lease payments as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit.

- The ED proposes detailed disclosure requirements for lessees as compared with Ind AS 17.

### Accounting by lessor

The accounting treatment for lessor in the ED is similar to the accounting requirements in Ind AS 17. A lessor would continue to classify its leases as operating leases or finance leases, and would account for those two types of leases differently.

However, the ED proposes additional disclosure requirements for lessors as compared to Ind AS 17, such as, disclosure of maturity analysis of lease payments; quantitative and qualitative explanation of significant changes in carrying amount of new investment in finance leases, etc.

### Provision for lease modification

The ED of Ind AS 116 contains specific provisions for lease modification for lessor and lessee.

- *Lease modification by a lessee:* A lessee should account for a lease modification as a separate lease if both the given conditions are met:
  - a) The modification increases the scope of the lease by adding the right to use one or more underlying assets, and
  - b) The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Further, for a lease modification that is not accounted for as a separate lease, the lessee should account for the remeasurement of the lease liability by:

- a) Decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee should recognise in the

statement of profit and loss any gain or loss relating to the partial or full termination of the lease.

- b) Making a corresponding adjustment to the right-of-use asset for all other lease modifications.
- *Lease modification by a lessor:*

### Finance lease

A lessor should account for a modification to a finance lease as a separate lease if both the given conditions are met:

- a) The modification increases the scope of the lease by adding the right to use one or more underlying assets, and
- b) The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Further, for a finance lease that is not accounted for as a separate lease, a lessor should account for the modification in the following manner:

- a) If the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor should:
  - i. Account for the lease modification as a new lease from the effective date of the modification, and
  - ii. Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
- b) Otherwise, the lessor should apply the requirements of Ind AS 109, Financial Instruments.

### Operating lease

A lessor should account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Ind AS 17 does not specifically provide how to account for lease modification.

### Presentation

The ED includes the following presentation requirements for a lessee and a lessor with respect to right-of-use asset and lease liabilities.

## Overview of the ED on Ind AS 116

### Lessee

- *In the balance sheet:* A lessee should either present in the balance sheet, or disclose in the notes:
  - a) Right-of-use assets separately from other assets
  - b) Lease liabilities separately from other liabilities.

However, right-of-use assets that meet the definition of investment property should be presented as an investment property.
- *In the statement of profit and loss:* Interest expense on the lease liability should be presented separately from the depreciation charge for the right-of-use asset.
- *In the statement of cash flows:* A lessee should classify:
  - a) Cash payments for the principal portion of the lease liability within financing activities
  - b) Cash payments for the interest portion of the lease liability within financing activities, applying the requirements in Ind AS 7 for interest paid, and
  - c) Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

### Lessor

A lessor should present underlying assets subject to operating leases in its balance sheet according to the nature of the underlying asset.

### Key differences between the ED and IFRS 16

- *Fair value model:* IFRS 16 provides that if a

lessee applies the fair value model in IAS 40, *Investment Property* to its investment property, it should apply that fair value model to the right-of-use assets that meet the definition of an investment property. Since Ind AS 40, *Investment Property*, does not allow the use of fair value model, this guidance has been excluded from Ind AS 116.

- *Presentation of right-of-use assets:* Unlike IFRS 16, the ED does not provide an option to present right-of-use assets within the same line item as that within which the corresponding assets would be presented if they were owned. A similar option for presentation of lease liability has also been excluded from the ED.
- *Classification of lease liability:* While IAS 7 provides an option of classifying interest paid as an operating or financing activity, Ind AS 7 requires interest paid to be treated as a financing activity. Accordingly, the ED has been modified to specify that cash payments for the interest portion of a lease liability would be classified as financing activity applying Ind AS 7.

### Transition

The ED on Ind AS 116 proposes a range of transition options, with several practical expedients. Significantly, an entity would not be required to reassess whether a contract contains a lease at the date of initial application. Instead, it would be permitted to:

- Apply Ind AS 116 to contracts that were previously identified as leases applying Ind AS 17
- Not apply Ind AS 116 to contracts that were not previously identified as containing a lease applying Ind AS 17.

## Our comments

- The issuance of the ED indicates that ICAI is committed to keep Ind AS updated with revisions made to IFRS and continue with its process of convergence with IFRS. The ED is largely converged with IFRS 16, except for a few minor differences.
- IFRS 16 is applicable internationally from 1 January 2019. Accordingly, Ind AS 116 has been proposed to be made effective from 1 April 2019.
- The new standard, once notified by the MCA, is expected to affect a wide variety of sectors and entities, including airlines, retailers, power generation companies, companies that seek large volumes of equipment financing and other companies with large lease portfolios. The larger the lease portfolio, the greater the impact on key reporting metrics and financial ratios. The key change will be the increase in transparency and comparability. Additionally, certain types of arrangements may require detailed evaluation to determine if they meet the definition of leases as per Ind AS, for example, outsourcing contracts, third party manufacturing contracts, power purchase arrangements, etc.
- Companies should take note of the draft requirements and should start assessing the impact both on current and prospective leasing arrangements. Companies with large lease portfolios should also consider the impact on related information systems and processes that may be necessary to implement the new accounting requirements.
- Additionally, further clarity may be required from the Central Board of Direct Taxes (CBDT) on how to account for leases from a tax perspective.

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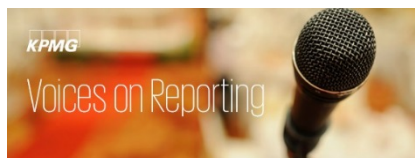
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## Voices on Reporting



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

In our recent call on Wednesday, 5 April 2017, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders pertaining to the quarter ended 31 March 2017.

Our call included updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc.

In our VOR quarterly updates, we have summarised key updates relating to the quarter ended 30 June 2017 from the MCA, the SEBI, the RBI, the Institute of Chartered Accountants of India (ICAI), the Insurance Regulatory and Development Authority of India (IRDA) and the Central Board of Direct Taxes (CBDT).

## Missed an issue of our Accounting and Auditing Update or First Notes



### Issue no. 11/2017 – June 2017

Continuing with our series of articles on the revised requirements of the Companies Act, 2013 (2013 Act), this month's edition of the Accounting and Auditing Update (AAU) carries an article describing key responsibilities of directors, and also compares the requirements of the 2013 Act with the Securities and Exchange Board of India's (SEBI) regulations with regard to directors.

In the second article of the series covering Ind AS implementation issues for entities in the financial services sector, we explain the concept of a business model assessment to be undertaken by banks on transition to Ind AS for loans advanced and investments made.

This edition carries an article explaining the deemed cost exemption for property, plant and equipment and also highlights the challenges/implications in accounting for the same on Ind AS transition. This article also covers the implication on Minimum Alternate Tax (MAT) computation both on transition and in subsequent annual financial statements.

Our article on accounting for lease of land under Ind AS emphasises the need to assess all of the lease classification indicators before classifying a lease as an operating or a finance lease.

The publication also carries regular round up of regulatory updates in India and internationally.



### MCA proposes to notify the provisions relating to restriction on layers of subsidiaries under the Companies Act, 2013

14 July 2017

The provisions (proviso to Section 2(87) and 186(1) of the Companies Act, 2013 (2013 Act)) are aimed at monitoring misuse of multiple layers of subsidiaries for diversion of funds/siphoning off funds and ensuring minority investor protection. Currently, proviso to Section 2(87) is not notified but Section 186(1) is currently applicable to companies.

On the basis of reports received by the Ministry of Corporate Affairs (MCA), it pointed out that certain companies could create shell companies for diversion of funds or money laundering. Therefore, MCA decided to operationalise the provisions relating to the restriction on number of layers for holding companies although the Companies (Amendment) Bill, 2016 proposes to remove the restrictions in these two sections.

Accordingly, MCA through a notice dated 28 June 2017 proposed the following:

- Notification of the proviso to Section 2(87) of the 2013 Act
- Insertion of new sub-rule 5 'Restriction on number of layers for certain holding companies' to the Companies (Specification of Definitions Details) Rules, 2014.

This issue of First Notes provides an overview of the MCA proposals.

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