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Ind AS 17 – Leases

The July-September 2015 quarter has seen India's office property market record the strongest activity in the Asia-Pacific region. The Indian office property market has reportedly touched USD 1 billion for the first time, contributing to more than half of Asia's gross lease rental receipts. Property acquisition is a must for new entrants in the Indian market and for those expanding across the country. In our November edition of Assurance Insights, we discussed the nuances of acquisition, recognition and measurement of property, plant and equipment and investment property. In this month's edition, we take our readers across lease accounting. To acquire vehicles, machinery, software, real estate, etc. in lease arrangements is a regular feature of business operations. Under the Indian GAAP, Accounting Standard 19 (AS 19) provides guidance on the subject of leasing. Indian Accounting Standard 17 (Ind AS 17): Leases is the IFRS converged counterpart of AS 19. The impact of adopting Ind AS 17 will be felt across all sectors and industries. This month's edition takes our readers across a comparison, between the existing AS 19 and Ind AS 17, where we highlight the value addition made by the new standard.

In this issue, we discuss:

a) Overview
b) Date of inception and commencement of leases
c) Treatment of initial direct costs
d) Operating lease incentives
e) Land leases
f) Embedded leases
g) Emphasis on substance of arrangement over its mere legal form
h) Sale and leaseback
i) Straight lining of operating lease payments
j) International standing on lease
k) Comprehensive comparison

Overview

	Land Leases	Initial Direct Costs	Operating Lease Incentives	Implied/Embedded Leases
Accounting Standard 19 (AS 19)	The Indian GAAP currently has no standard that specifically prescribes the treatment for land leases. AS 19 specifically excludes land leases from its scope. In practice currently, long-term land leases are classified as fixed assets.	Lessors (other than manufacturer/dealer lessors) are free to choose in the case of: **<u>Finance Lease</u>** Add initial direct costs to lease receivable ***or*** Expense out these costs immediately **<u>Operating Lease</u>** Add initial direct costs to the carrying amount of the leased asset and expense out over the lease term **or** Immediately expense out the entire amount	No specific treatment is prescribed to deal with incentives provided to lessees to secure operating lease contracts.	No guidance prescribed to identify or account for leases rooted in a purchase or sale transaction.
Indian Accounting Standard 17 (Ind AS 17)	Ind AS 17 classifies land leases as either finance or operating leases at the very inception of the lease. Long-term land leases are classified as finance leases regardless of the transfer of title.	For lessors (other than manufacturer/ dealer lessors), initial direct costs (these exclude general and selling overheads) are included in: **<u>Finance Leases</u>** Amount of finance lease receivable **<u>Operating Leases</u>** Carrying amount of leased asset and are expensed out over the lease term. The option of immediately expensing out is not available.	Lease incentives provided to the lessee will form a part of the consideration paid for the said lease arrangement.	Examination of the substance of contracts/arrangements which may imply the presence of a lease. Such a lease, if identified, is to be classified as either finance/operating lease and accounted for accordingly.

Date of inception and commencement of leases

Inception

Ind AS 17 states that classification of leases as operating or finance for the purposes of accounting must be done at the date of inception of the lease. The standard defines the date of inception to be the earlier of:

- The date of lease agreement; or
- The date of committing to the principal provisions of the lease by the parties.

Commencement

In essence, a lease agreement commences when the lessee has been granted the right to use the asset which is the subject matter of the lease. The date on which the lessee exercises the right to use the asset is considered the commencement date. On this date, the initial recognition of assets and liabilities (in case of finance leases) and incomes and expenses (in case of operating leases) takes place in the financial statements of the lessee and lessor.

This standard identifies that not all lease tenures may start with immediate effect from the date of the lease agreement or from the date of receiving, in principle, commitments from the involved parties. Hence, a clear distinction is made between the date of inception of the lease and the commencement of lease by defining both separately.

AS 19 does not distinguish between the dates of inception and commencement. The underlying assumption made by AS 19 is that the lessee starts using the asset either from the date of the lease agreement or from the date on which the principal provisions are being committed to. This may not always be the case as, due to various operational reasons, the lessee may start exercising the right to use an asset on a date other than the agreement date or when the principal commitment was made.

Treatment of initial direct cost

In the process of securing a lease contract, the lessor often incurs costs such as commission and legal fees. These costs are incurred solely to ensure the generation of lease rental income. These costs are similar to directly attributable costs incurred for the acquisition of property, plant and equipment. Ind AS 17 prescribes treatment wherein these costs are added to the carrying amount of the leased asset (capitalised). The treatment of these costs in finance and operating leases in the books of the lessor and the lessee shall be as follows:

For finance leases

<u>If incurred by the lessor</u>

Who is a non-manufacturer/non- dealer

The implicit interest rate of the lease is specifically defined to include the initial direct costs in the amount of the finance lease receivable. The only exception is general administrative overheads which are not considered a part of the initial direct costs by the standard.

Who is a manufacturer/dealer

At the commencement of the lease term, all initial direct costs shall be recognised as expenses.

AS 19 provides the lessor with an option to either immediately charge initial direct costs on incurrence (i.e. expense out in the statement of profit and loss); or amortise the initial direct costs over the lease period.

<u>If incurred by the lessee</u>

The initial direct costs are added to the amount which is recognised in the books of the lessee as an asset.

For operating leases

<u>Lessor accounting</u>

Initial direct costs are capitalised by being added to the carrying amount of the leased out asset and are then matched as an expense on the basis of the lease income over the lease term.

AS 19 provides the option to immediately recognise the entire cost as an expense in the statement of profit and loss or defer over the lease period and proportionately set off against the lease income for each accounting period.

<u>Lessee accounting</u>

No specific guidance is given in the standard. Accordingly, initial direct costs may be expensed as and when incurred.

Operating lease incentives

Leasing of property and other assets is a competitive business. To secure lease contracts, it is common for lessors to provide assets on lease with incentives like:

- Rent-free initial periods
- Reimbursement of expenses incurred on the asset by the lessee and so on

Ind AS 17 recognises such incentives as a relevant cost incurred by the lessor to secure the lease contract. Lease incentives are hence recognised as an essential part of the net consideration agreed upon for the lease agreement.

For example, if the asset maintenance expenses which the lessee would normally bear have been paid by the lessor as an incentive, the lessor shall recognise these incentives as a cost and shall set them off against the lease rental income received for the period.

AS 19 provides no guidance on these incentives which are an underlying cost to the lessor.

Land leases

There is no guidance for accounting for land leases and composite leases of land and building in AS19. Without any standard prescribing the specific treatment for these lease agreements, the Indian GAAP is more or less silent on the subject.

The absence of authoritative guidance on land leases has led to questions regarding the treatment of inflationary adjustments, initial recognition, initial measurement , straight lining of lease rentals, etc. remaining unanswered. In practice currently, entity specific polices and industry specific practices are driving the resolution and treatment of these unanswered queries.

One common practice in this area based on the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is **recognising upfront payments made for long-term leases as part of the fixed assets at historical cost in the books of lessee.** Such long-term leases are generally for a period extending up to 99 years or more with renewal spanning to a similar period.

Ind AS 17 requires that land taken on lease be classified either as finance or operating lease depending on the substance of the arrangement.

Exception-based on intent of acquisition

If the lessee uses the land acquired under a finance lease for any or both of:

- Capital appreciation purposes
- Earning rentals by letting it out

The land, in substance, falls under the definition of 'Investment property' as per Ind AS 40: Investment Property and its treatment is no longer prescribed by Ind AS 17.**Composite lease of land and buildings**
This standard provides guidance in cases where land and building are both included in a lease agreement. Here, such lease agreements shall be treated by:

- Separately classifying the land and building either as operating or finance leases on the date of inception.
- Amounts paid as lease rentals being allocated to the now separately classified assets

In case the amount of the lease to be recognised for the land element in a lease of land and building is considered immaterial by the management, the whole lease shall be treated as a single unit i.e. lease of building. In certain cases, the allocation of lease rentals amongst land and building may be impracticable. This challenge can be resolved by classifying the entire lease (both land and building) as a finance lease. However, if it is clear that both components are used in the spirit of operating leases, the entire lease shall be classified as an operating lease.

Embedded leases

Sometimes entities may enter into agreements that convey or receive the right to use an asset in return for a payment or series of payments without such agreements actually taking the legal form of a lease. For example:

a) An entity may choose to buy the entire output produced from a specific asset owned by the supplier; or
b) The supplier may own just a single asset, the entire output of which is either purchased or consumed by a single entity.

Even though the above agreements seem to be in the nature of a regular sale and purchase, *the use of a specified asset by the owner for a single unrelated entity is the base of such agreements*. Going beyond the legal form of the agreement, it is clear that the lessee is the party who ultimately benefits from the use of the asset. Such agreements, though not in the legal form of a lease, are lease agreements. This substance over form identification of leases is a differentiating edge that Ind AS 17 has over AS 19.

AS 19 provides no guidance on agreements which are, in substance, leases, but do not take the legal form of a lease. The ongoing practice under the Indian GAAP is to recognise such transactions as per their legal form. The Indian GAAP does not expressly disallow accounting for such agreements as leases.

Emphasis on substance of arrangement over its mere legal form

The standard goes beyond the legal form of such agreements and determines whether or not they contain a lease by asking the following questions:

Is the fulfilment of such an arrangement dependent upon the use of an asset?
Mere identification of an asset as a part of the contract is not enough. The arrangement or contract must be dependent on the usage of the asset.

Does such an arrangement convey the right to use an asset?
The purchaser of the output generated from the asset in question has the implied right of access to the asset. Also, operations to be carried out by the use of the asset can be directed by the said purchaser. Rights of access and control enable the purchaser (lessee) to assert his control over it as long as production continues (lease term).

If the answer to both of the above questions is in the affirmative, the activity of leasing an asset(s) is embedded into the substance of such agreements. The standard requires that such leases, once identified, be classified as either finance or operating leases depending upon the terms of the contract.

Examples of such agreements are:
a) Outsourcing agreements
b) Take or pay contracts
c) Telecom projects that provide the purchasers the right to use network capacity.

Sale and leaseback transactions

The accounting treatments of any profits or losses that are to arise in a sale and leaseback transaction resulting in an operating lease are the same as per Ind AS 17 and AS 19. The differences in accounting treatments between Ind AS 17 and AS 19 arise in cases where sale and leaseback transactions result in finance leases. The excess of sale proceeds over the carrying amount of the asset shall not be immediately recognised as an income by the seller lessee. This excess, if any, shall be amortised over the lease term. Ind AS 17 does not specify the method of such amortisation.

AS 19 also prescribes the deferral and amortisation of sale proceeds exceeding the carrying amount. However, AS 19 prescribes that the amortisation shall be carried out over the lease term in proportion to the depreciation of the leased asset.

Straight lining of operating lease rentals

Ind AS 17 specifically excludes inflationary adjustments in lease rentals from being straight lined. On the other hand, AS 19 requires straight lining of all increases in operating lease rentals whether due to inflationary adjustments or contractual stipulations.

International standing on leases

On 13 January 2016, The International Accounting Standard Board (IASB) issued the long-awaited standard on leases, IFRS 16. The IASB has been developing this standard for over a decade with the Financial Accounting Standard Board (FASB). The FASB is expected to release its counter-part of IFRS 16 in the first quarter of this calendar year. So far, the US GAAP has been deriving guidance from ASC 840 for the purpose of lease accounting.

Comprehensive comparison

Point of difference	Ind AS	IFRS (IAS 17)	US GAAP
Scope of leases	Lease accounting guidance in Ind AS does not restrict itself to property, plant and equipment. Accordingly, it may be applied to intangible assets as well.	Similar to Ind AS	Lease accounting guidance is restricted to only property, plant and equipment. A few specifications for the accounting of software leases are available.
Classification of leases	The classification of leases depends on the substance of the transaction and the transfer of substantial risks and rewards incidental to ownership.	Similar to Ind AS	For the classification of a lease as a finance lease, four underlying conditions must be satisfied: Ownership transfer of the property to the lessee; Bargain purchase option; Lease term in relation to the economic life of the asset; and Present value of the minimum lease payments in relation to fair value of the leased asset.
Composite leases of land and building	The land and building elements are accounted for separately, subject to the exception that the land element is considered immaterial by the management. There is no material threshold prescribed.	Similar to Ind AS	Land and building will be accounted for as separate elements only if the land element in a composite lease of land and building exceeds 25% of the fair value of the leased property.

Point of difference	Ind AS	IFRS (IAS 17)	US GAAP
Straight lining of lease rentals	Straight lining is not required to the extent that the increase in lease rentals is due to inflation.	No such exemption is given in IFRS.	No such exemption is given in the US GAAP.
Sale and leaseback transactions	The gain in sale and leaseback transactions which result in a finance lease is amortised over the lease tenure. The gain in sale and leaseback transactions of operating leases is recognised immediately. The immediate recognition and amortisation is done irrespective of the amount of gain.	Similar to Ind AS	The gain in a sale and leaseback transaction is amortised over the lease term. Only minor gains are recognised immediately.
Economic life of leased asset	The quantification of 'major part of the economic life' of a leased asset is subjective and not expressly defined in the standard.	Similar to Ind AS	The 'major part of the economic life' of the asset is defined as equalling or exceeding 75% of the economic life of the asset.
Substantial amount of the fair value.	The present value of the minimum lease payment equalling a substantial amount of the fair value of the leased asset is one of the thresholds for determining whether the lease is a finance lease. 'Substantial amount of fair value' is subjective and has not been expressly defined in the standard.	Similar to Ind AS	It is prescribed that the 'substantial amount of the fair value of the leased asset' is one equalling or exceeding 90% of the fair value.
Renewal or extension of leases	If the period covered by the renewal option is exercised based on the original lease terms, such extension does not amount to a new lease agreement.	Similar to Ind AS	The extension of a lease term beyond the original lease term, even if based on the original terms of agreement of the lease, constitutes a new lease agreement.
Present value of Minimum Lease Payments (MLPs)	Generally, the rate implicit in the lease is used to discount MLPs.	Similar to Ind AS	Generally, the rate implicit in the lease is used to discount MLPs if this rate is known and lower than the incremental borrowing rate.
Leveraged lease accounting	It does not permit leveraged lease accounting.	Similar to Ind AS	Special accounting is permitted in case of leveraged accounting.

In retrospect

Ind AS 17 is more of a substance-based guideline compared to AS19. Accounting for land leases which earlier had no specific guidance in the Indian GAAP finds guidelines being set out in Ind AS 17. Recognition of embedded leases will also add value to the quality of financial information being reported. With international pronouncements being expected on the matter, lease accounting will be an area followed keenly by accountants and reporting entities across the world.

Upgraded accounting standards

Bridging the gaps in GAAP

The law governing companies in India was revamped in 2013. One amongst many of the significant reasons for revising the law was to pave way for a two-tier system of accounting standards. The two-tier system being Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRSs) for listed and large companies and the upgraded version of existing Accounting Standards (upgraded AS) for other companies. With the timelines rolled out for adoption of Ind AS, the next step was clearly the issue of these upgraded AS.

Evolution of upgraded AS

"One size fits all" does not work when it comes to financial reporting standards.

Adoption of Ind AS, which will be in a phased manner, would cover all the listed companies and those unlisted companies with a net worth of INR 2.5 billion or more. For other companies (unlisted companies with a net worth of less than INR 2.5 billion) and all non-corporate entities, the Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 and the accounting standards notified by the Institute of Chartered Accountants of India (ICAI) would continue to apply respectively. The wide gap between these accounting standards and the Ind AS was seen as a setback in the process of benchmarking with global financial reporting standards.

To address this, the ICAI issued exposure drafts for five of the upgraded AS at the request of Ministry of Corporate Affairs (MCA). These exposure drafts attempt to bring the accounting standards (applicable to smaller companies and non-corporate entities) as close to Ind AS as is practically feasible.

The numbering of these upgraded AS is consistent with the numbering of Ind AS. These are highlighted the following table:

Subject Matter	Existing AS	Upgraded AS	Ind AS
Inventories	AS 2	AS 2	Ind AS 2
Accounting policies, changes in accounting estimates and errors	AS 1 and AS 5	AS 8	Ind AS 8
Events after reporting date	AS 4	AS 10	Ind AS 10
Government grants	AS 12	AS 20	Ind AS 20
Statement of cash flows	AS 3	AS 7	Ind AS 7

Although the applicability date for the upgraded AS are yet to be announced, the ball has been set into motion with the issuance of exposure drafts.

This paradigm shift in the financial reporting standards that aims to bring Indian reporting standards at par with global best practices will have to be diligently addressed by all stakeholders. Smaller companies will have precedents to look forward to from their larger counterparts who would have already adopted Ind AS. Having an effective plan at an early stage for implementation specifically addressing the changes required in the accounting system as well as establishing operational trainings required would definitely inoculate the companies from the inefficiencies that changes in external environment generally brings.

To assist you in this phase, we will be presenting to you a comparative account of upgraded AS vis-à-vis the existing AS and the Ind AS, in the months to come.

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Our offices

Mumbai
19, Adi Marzban Path
Ballard Estate, Fort
Mumbai 400 001
T: +91 22 6730 9000

Pune
VEN Business Centre
Baner–Pashan Link Road
Pune 411 021
T: +91 20 6720 3800

Hyderabad
6-3-249/3/1, SSK Building
Ranga Raju Lane
Road No. 1, Banjara Hills
Hyderabad 500 034
T: +91 40 2325 1800

New Delhi
B-376
Nirman Vihar
New Delhi 110 092
T: +91 11 4252 8800

Gurgaon
German Centre for Industry and Trade Delhi
Building No. 9, Tower B
Level 12, DLF Cyber City Phase III
Gurgaon 122 002

Chennai
Office No. 3, Crown Court
128 Cathedral Road
Chennai 600 086
T: +91 44 4208 0337

Bengaluru
Office No. 312/313, Barton Centre
Mahatma Gandhi Road
Bengaluru 560 001
T: +91 80 4140 0131

Toronto
269 The East Mall
Toronto
ON M9B 3Z1
Canada
T: +1 647 707 5066

www.skpgroup.com

NEXIA INTERNATIONAL Member firm of Nexia International

Connect with us

skpgrp.info@skpgroup.com

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