What’s in store for us ?

- Ind AS 116- Why and What is it ?
- How to determine whether a contract contains a lease ?
- What next if the contract contains a lease ?
- What happens if a contract contains a lease ?
- What happens to lease liability and ROU Asset ?
- Example and accounting entries

Ind AS 116 – Why and what is it ?

Why Ind AS 116 ?

Showing existence of right as assets :

• With introduction of Ind AS , the focus has shifted from risk and reward to control.

• In Ind AS 10, Fixed assets represented a resource with economic benefit of >1 year.

• Ind As 116 combines control and >1 year economic benefit concept and requires the entity to capitalize right to use assets.

Disclosure of hidden liabilities :

• Many leases have non cancellation clause (lock in period) for which payment is certain.

• The committed liabilities are disclosed as a pert of notes.

• Ind AS 116 will now bring the commitment liabilities in to balance sheet after considering present value impact.

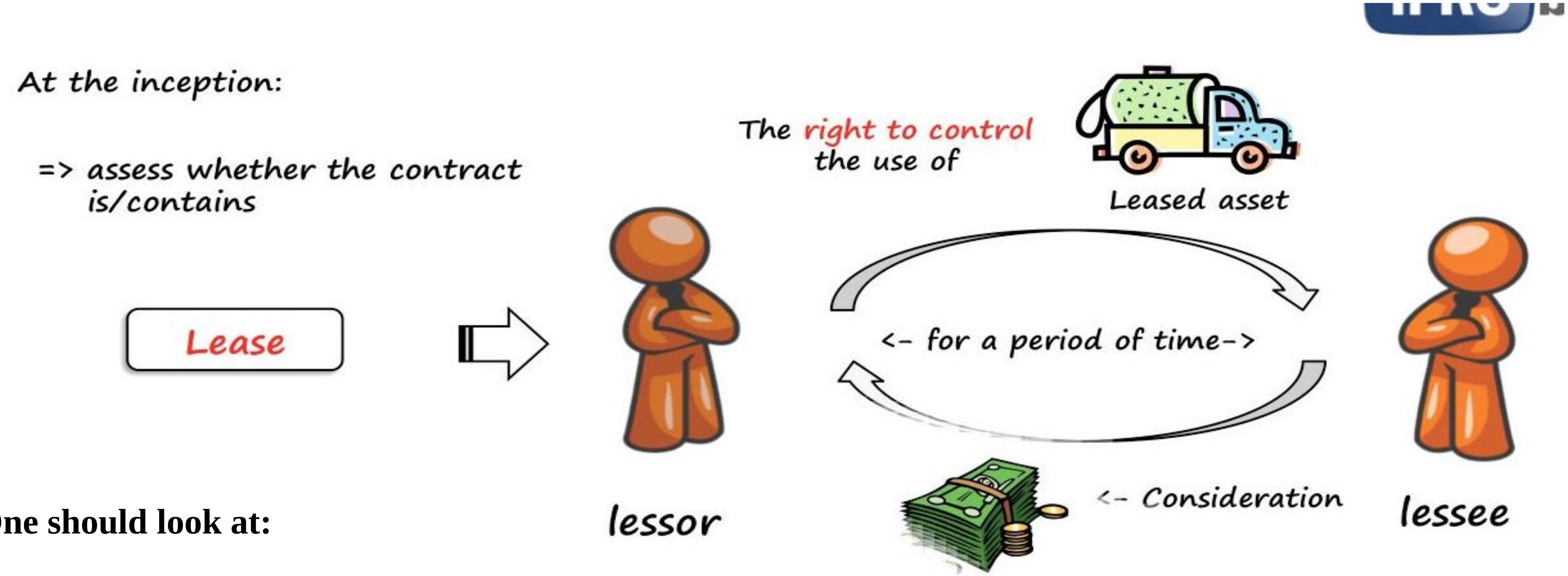
What is Ind AS 116 (IFRS 16)?

➢ The standard introduced w.e.f April 01, 2019 replaces the erstwhile Ind AS-17 on leases .

➢ No more classification of leases as operating or finance by the lessee.

➢ No significant changes in accounting for leases by a lessor.

How to determine whether a contract contains a lease ?



One should look at:

Can the asset be identified? E.g. is it physically distinct?

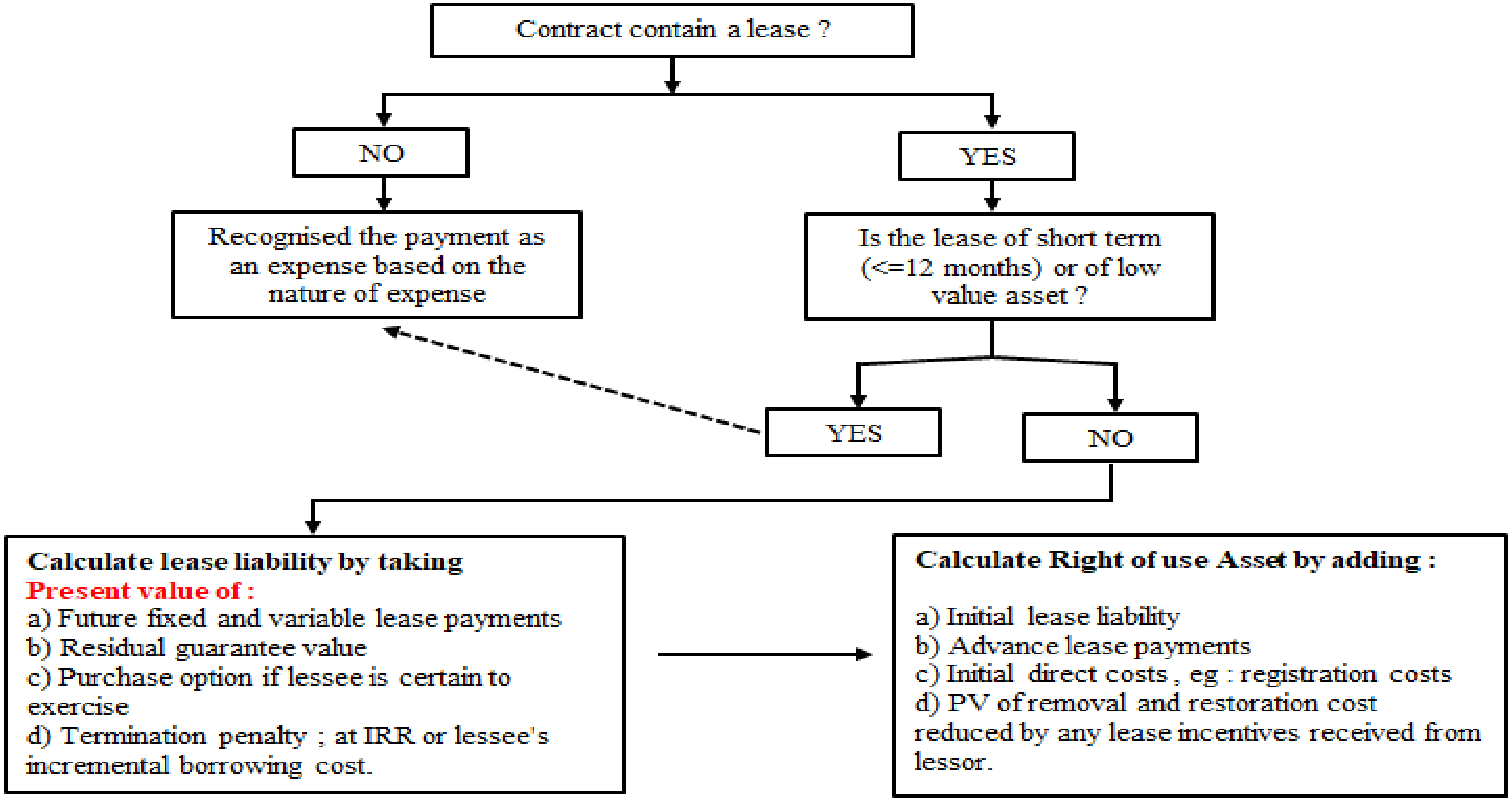
Can the lessee decide about the asset's use?

Can the lessee get the economic benefit from the use of that asset?

Can the lessor substitute the asset during the period of use?

If answer to these questions is yes ? Then the contract may contain a lease.

What next if the contract contains a lease ?



What happens to lease liability and ROU Asset ?

LEASE LIABILITY	ROU ASSET
➢ Lease liability represents present value of future payments to the lessor. ➢ Lease liability is **increased** by the amount of interest on the discounted value and **reduced** by the lease payments. ➢ Interest is shown as finance cost in the P&L Account.	➢ ROU Asset represents the right over the asset over the lease term. ➢ ROU Asset is depreciated in a straight line basis over the lease term or over the life of the asset if lessee has an intention to purchase the asset. ➢ Depreciation of ROU Asset is shown as depreciation and amortization cost

Depreciation + Interest = Rent/Hire charges cost

Let’s understand with help of an example !

A lessee enters into a 15-year lease of one floor of a building. Lease payments are Rs. 10,00,000 per year, all payable at the end of each year. To obtain the lease, the lessee incurred initial direct costs of Rs. Nil.

The interest rate implicit in the lease is 11% per annum. The present value of the lease payments is Rs. 71,90,869.58.

At the commencement date, the lessee incurs the initial direct costs is Nil and measures the lease liability Rs. 71,90,869.58.

The carrying amount of the right of use asset in balance sheet after these entries is Rs. 71,90,869.58 and consequently the annual depreciation charge will be Rs. 479391.31 (Rs.7190870 x 1/15) in the profit or loss statement.

Accounting entries !

Accounting entries in IND AS 17			
Rent exp a/c	Dr.	10,00,000	
To Rent payable (party)			10,00,000
Rent payable (party) a/c	Dr.	10,00,000	
To Bank a/c			10,00,000

Accounting entries in IND AS 116 at year zero			
Right of Use a/c	Dr.	71,90,870	
To Lease liability a/c			71,90,870

	Accounting entries in IND AS 116 at end of year one			
	Depreciation a/c	Dr.	4,79,391	
	To Right of Use a/c			4,79,391
	Interest exp a/c	Dr.	7,90,996	
	To Lease liability			7,90,996
If payment made	lease Liability a/c	Dr.	10,00,000	
	To Rent exp			10,00,000
If payment not made	Lease liability a/c	Dr.	10,00,000	
	To Bank a/c			10,00,000

Impact on P&L due to implementation of IND AS 116

Year	Opening Balance	Finance cost	Rental	Closing balance	Amortization	Total exp	Impact
1	71,90,870	7,90,996	10,00,000	69,81,865	4,79,391	12,70,387	(2,70,387)
2	69,81,865	7,68,005	10,00,000	67,49,870	4,79,391	12,47,396	(2,47,396)
3	67,49,870	7,42,486	10,00,000	64,92,356	4,79,391	12,21,877	(2,21,877)
4	64,92,356	7,14,159	10,00,000	62,06,515	4,79,391	11,93,550	(1,93,550)
5	62,06,515	6,82,717	10,00,000	58,89,232	4,79,391	11,62,108	(1,62,108)
6	58,89,232	6,47,816	10,00,000	55,37,048	4,79,391	11,27,207	(1,27,207)
7	55,37,048	6,09,075	10,00,000	51,46,123	4,79,391	10,88,467	(88,467)
8	51,46,123	5,66,074	10,00,000	47,12,196	4,79,391	10,45,465	(45,465)
9	47,12,196	5,18,342	10,00,000	42,30,538	4,79,391	9,97,733	2,267
10	42,30,538	4,65,359	10,00,000	36,95,897	4,79,391	9,44,750	55,250
11	36,95,897	4,06,549	10,00,000	31,02,446	4,79,391	8,85,940	1,14,060
12	31,02,446	3,41,269	10,00,000	24,43,715	4,79,391	8,20,660	1,79,340
13	24,43,715	2,68,809	10,00,000	17,12,523	4,79,391	7,48,200	2,51,800
14	17,12,523	1,88,378	10,00,000	9,00,901	4,79,391	6,67,769	3,32,231
15	9,00,901	99,099	10,00,000	0	4,79,391	5,78,490	4,21,510

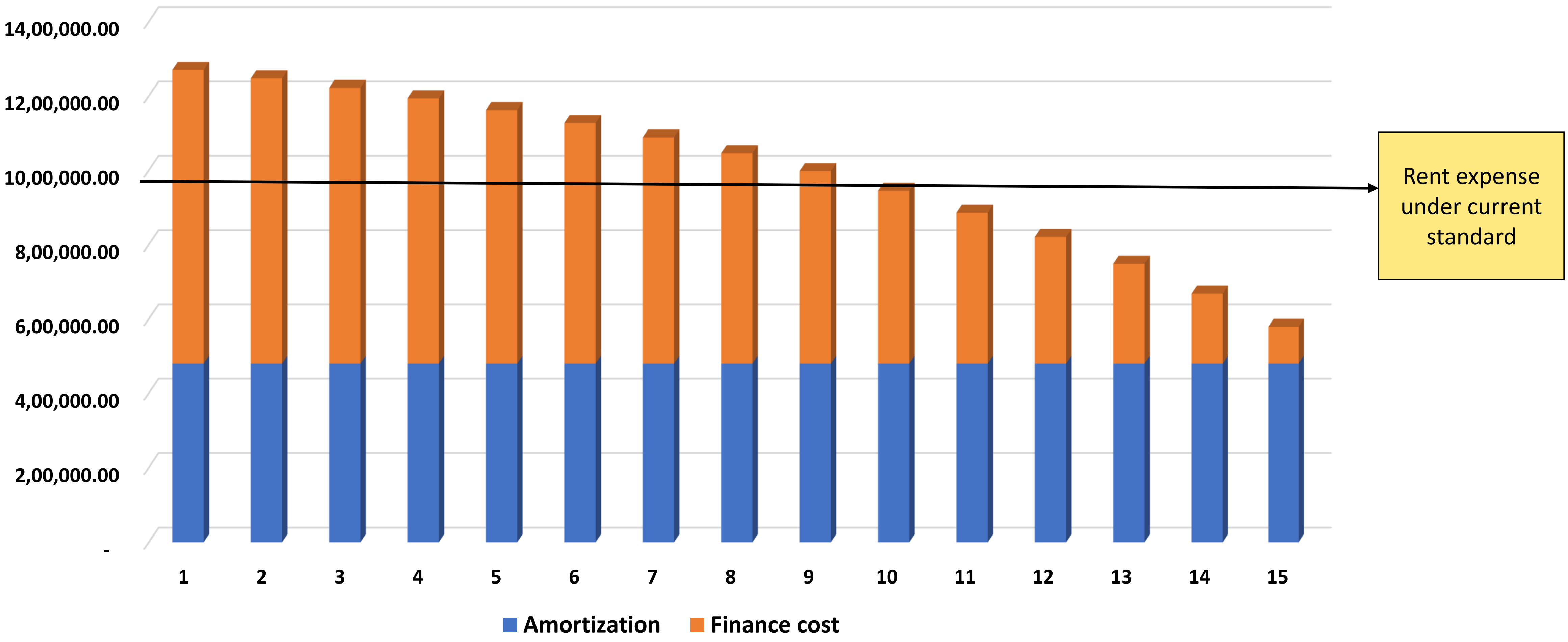
Let's understand with help of an example !

An illustration: Lessees – Extract of financials at end of year one			
Profit	**IND AS 17**	**IND AS 116**	**Impact**
Lease rental expense	(10,00,000)		10,00,000
EBITDA	(10,00,000)		10,00,000
Amortization charge		(4,79,391)	(4,79,391)
EBIT	(10,00,000)	(4,79,391)	5,20,609
Finance costs		(7,90,996)	(7,90,996)
(Loss) before tax	(10,00,000)	(12,70,387)	(2,70,387)
Balance Sheet	**IND AS 17**	**IND AS 116**	**Impact**
Assets	-	67,11,478	67,11,478
Liabilities	-	69,81,865	69,81,865
Equity	-	(2,70,387)	(2,70,387)

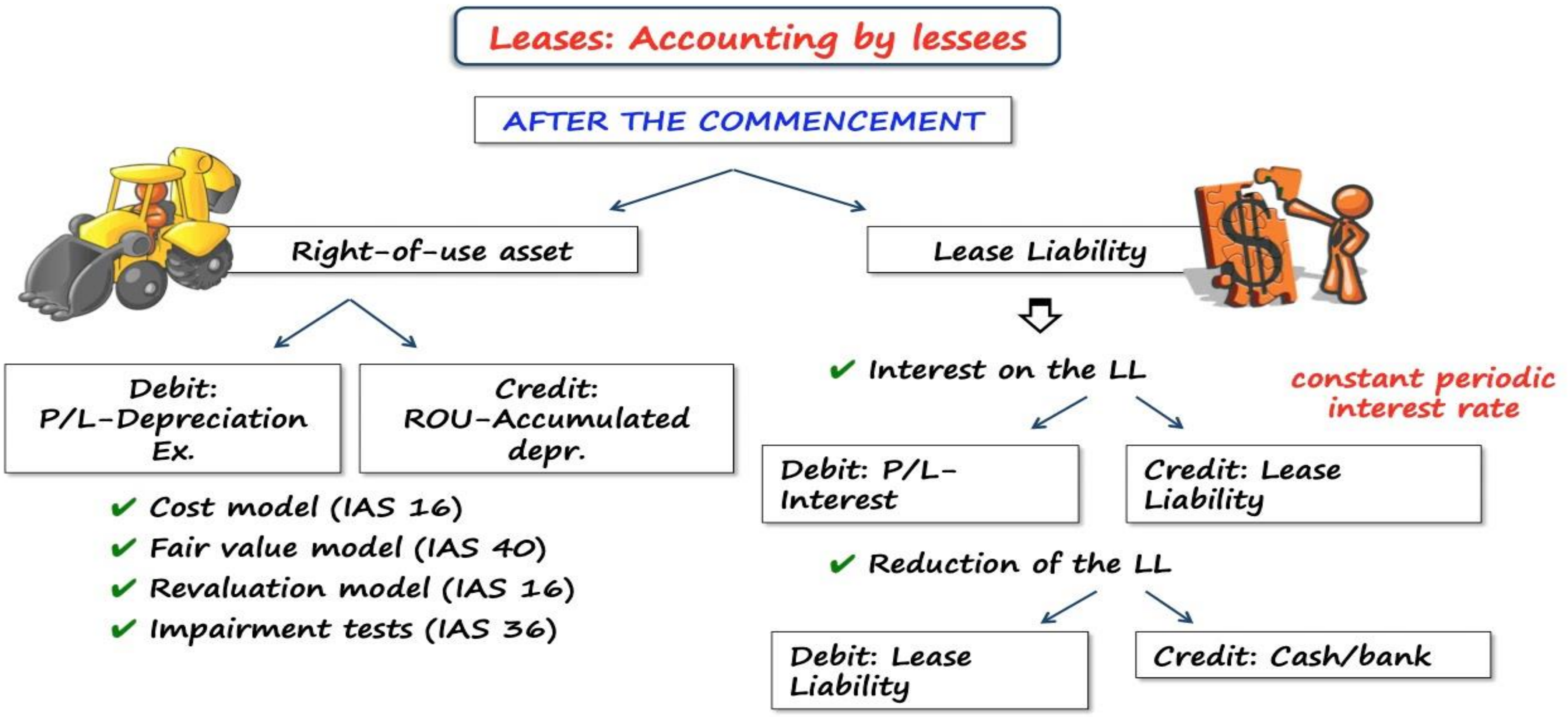
Assumptions

- One Lease
- CU1,000,000 rental p.a.
- No straight-lining required
- 15 year term
- 11% discount rate
- No contingent rentals
- Initial asset and liability CU7.2m

Analysis of expenses between IND AS 116 Vs IND AS 17



Accounting in a nutshell !



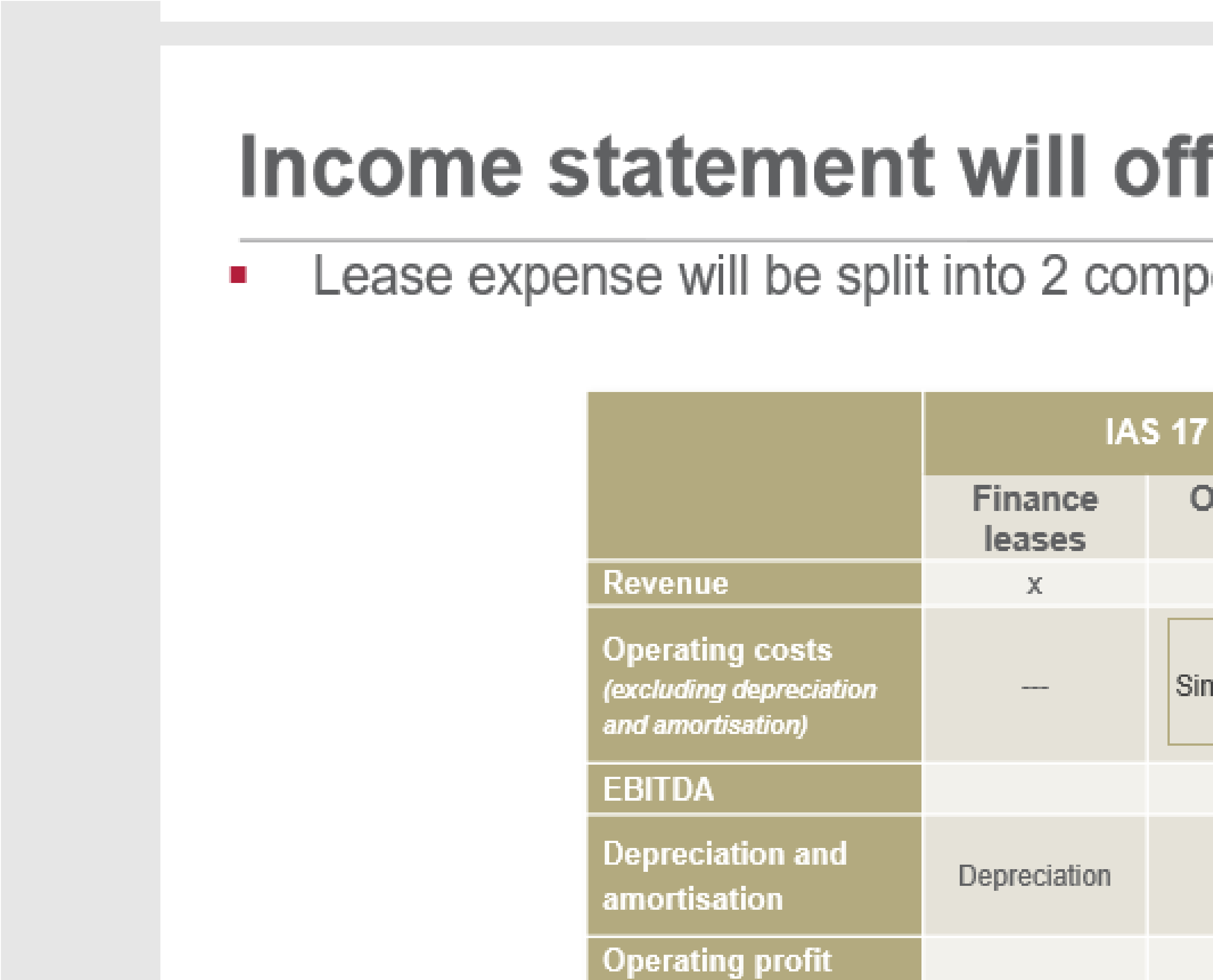
Impact on financial statements and performance indicators

BALANCE SHEET IMPACT

	Ind AS 17		Ind AS 116
	Finance leases	Operating leases	All leases
Assets		---	
Liabilities	$$	---	$$$$$$$
Off balance sheet rights / obligations	---	$$$$$	---

P&L IMPACT

Ind AS 17	Ind AS 116



Impact summarized

P&L Metrics, margins and ratios	Impact
EBIT and EBITDA	Increase
Return on assets	Lower
Asset turnover	Lower
Return on equity	Either side

Cash flow impact	Impact
Operating activities	Higher
Financing activities	Lower
Net cash flow	No change
Unlevered free cash flow*	Higher

Leverage Analysis	Impact
Debt/Equity	Higher
Interest coverage	Lower

** Assumes that adjustments to calculate free cash flow do not include lease liability principal repayments, which are included within financing activities under Ind AS 116*

Other Aspects

<u>Separating lease and non lease components :</u>

- Lessee given an option to segregate lease and non lease components of a contract.
- For example lessee may choose to segregate rent and maintenance services separately.

<u>Combination of leases :</u>

- Lessee may combine leases which are interlinked to each other and treat 2 leases as a single lease for accounting purpose.
- Combination maybe linked by payment, initial negotiation and continuation of lease.

<u>Modification of leases :</u>

- Modification of leases refers to changes in scope of lease or change in period or change in rates.

Changes in scope :

a) Scope decreases are accounted by calculating revised ROU Asset and liability with revised discounting rate and difference between existing balances are accounted in P&L.

b) Scope increases are accounted with same lease if the price does of new lease is not the standalone selling price and accounted as a separate lease if price is independent of the original lease.

Changes in Period and rate :

a) Same as change in scope (a) point and if increase, ROU and lease liability are increased.