THE STANDARD STANCE

Navigating Certain Complexities While Applying Ind AS 116 ‘Leases’

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The accounting for leases in the financial statements of lessees significantly changed when the Ministry of Corporate Affairs notified Ind AS 116 'Leases' effective from 1 April 2019.

Whereas under the previous guidance in Ind AS 17 'Leases', a lessee had to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet), the new model requires the lessee to recognise almost all lease contracts on the balance sheet. The only optional exemptions are for certain short-term leases and leases of low-value assets. Corporates to whom Ind AS is applicable have been applying Ind AS 116 for close to five years now. Based on our understanding of the application of Ind AS 116 by these corporates, we are discussing three areas wherein corporates could typically encounter complexities while applying Ind AS 116. We have also included relevant guidance of Ind AS 116 and the factors that the management should consider to assist in navigating the complexities in these areas.

Determining the identified asset – assessment of substantive substitution rights

The first criterion to be assessed in determining whether a contract between a customer and a supplier contains a lease is whether there is an identified asset. Typically, an asset will be explicitly identified in a contract (for example, by specifying the registration or chassis number of a car as well as a description of the manufacturer and model). Alternatively, a contract can involve the use of an identified asset if that asset is implicitly identified at the point at which it is made available for use by the customer.

Even if an asset is specified in a contract, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use at inception of the contract.

A supplier's right to substitute an asset is substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
- The supplier would benefit economically from the exercise of its right to substitute the asset. (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

Some contracts contain clauses where a lessor has the right to substitute an asset. However, unless the lessor has a compelling reason to exercise this right, it is not substantive. In such a case, the substitution right may be protective (rather than substantive) to ensure the supplier's interest in the asset is maintained.

In addition, Ind AS 116 requires that this substitution right must exist 'throughout the period of use'. If a substitution right were only exercisable upon the occurrence of a specific event, after a period of time has elapsed or on a specific date, then the substitution rights would not be substantive for the purposes of Ind AS 116 as they are not present 'throughout the period of use'.

When the supplier has a right or an obligation to substitute the asset, however if the asset can be substituted on or after a particular date and/ or after the occurrence of a specified event, Companies should evaluate whether the supplier's substitution right is substantive at inception of the contract using data, facts and circumstances prevalent at that point in time. Companies are not required to consider future events that are not likely to occur at the inception of the contract. Consequently, these are excluded from the evaluation of whether a supplier's substitution right is substantive throughout the period of use.

Examples in Ind AS 116 of future events that are not likely to occur:

- An agreement by a future customer to pay an above-market rate for the use of the asset
- The introduction of new technology that is not substantially developed at inception of the contract
- A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract
- A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract
- Where the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset far outweighing any perceived benefit to the lessor

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive.

Determining the lease term

If a contract is, or contains, a lease, then the next step is to determine the lease term. Generally, the lease term begins on the commencement date (i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods. The lease term should begin from the commencement date, i.e. when the asset is available for use, irrespective of when the lease payments begin or the inception date (i.e., the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease).

Entities need to consider the non-cancellable period and the enforceable period when determining the lease term in accordance with Ind AS 116. In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

The lease term also includes any periods covered by an option to extend the lease, if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease, if the lessee is reasonably certain not to exercise that option.

When assessing the lease term, various factors need to be considered to assess whether the lessee is reasonably certain to exercise the extension option (or not exercise the termination option), some of which would require applying significant judgement. We have discussed some of the factors which we believe are relevant; however, it should be noted that the below list is not exhaustive and the evaluation of these points may involve significant judgement and will depend upon the facts and circumstances of each case. While making the evaluation, it is possible that no one factor may be the sole determinant and two or more factors may have to be assessed collectively to determine the lease term.

Sr. No	Factors to be considered	Evaluation
1	Renew/ optional/ extension period of the lease at below-market rate.	If such renewal options exist, it may be an indicator that the lessee is reasonably certain to exercise the option to extend the lease.
2	Whether the location of the underlying asset provides an economic or operational incentive to renew the lease.	If the leasehold premises are situated in a prime location, say close to customer offices or employees' residences, it may be an indicator that the lessee is reasonably certain to renew the lease.
3	Leasehold improvements which are expected to have significant residual value and therefore can only be realised through continued occupancy of the leased property and/ or cost of relocation i.e., dismantling and reinstallation are significant.	If the lessee has incurred significant expenditure on leasehold improvements, it may be an indicator that the lessee is reasonably certain to exercise the extension option.
4	The importance of an underlying asset to the lessee's operations (e.g., whether the underlying asset is highly specialised and the availability of suitable alternatives).	In case the underlying asset is important to the lessee's operations and an alternative asset is not easily available, it may be an indicator that the lessee is reasonably certain to exercise the renewal option.

A lessee's past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised.

Determining the discount rate

Generally, *"The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate"*.

Ind AS 116 defines the interest rate implicit in the lease as, "the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor." The definition of the lessee's incremental borrowing rate states that the rate should represent what the lessee 'would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.'

In applying the concept of 'similar security', a lessee uses the right-of-use asset granted by the lease and not the fair value of the underlying asset. This is because the rate should represent the amount that would be charged to acquire an asset of similar value for a similar period. In practice, judgement may be needed to estimate an incremental borrowing rate in the context of a right-of-use asset, especially when the value of the underlying asset differs significantly from the value of the right-of-use asset.

The entity sometimes selects its Weighted Average Cost Of Capital (WACC) which is not appropriate to use as a proxy for the incremental borrowing rate because it is not representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings. The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated.

Determining the incremental borrowing rate

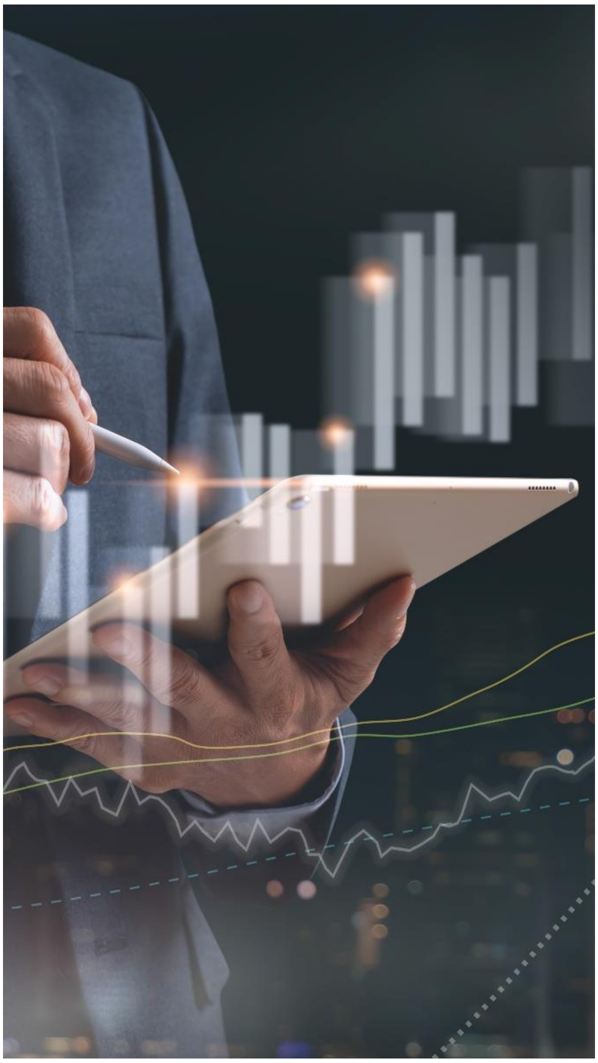
The starting point in estimating the incremental borrowing rate is a 'base rate', which may be a risk-free rate derived from government bonds or other types of low-risk financing with similar economic terms of lease such as period, point of time, value, etc. in the same geographical area. There should not be any significant time gap in the timing of cash flows between the risk-free rate period and the lease term. Further, while determining the discount rate, add financing factor to adjust the base rate for credit risk factors. The base rate and the credit spread so determined relate to an unsecured borrowing position, which should then be adjusted for the asset factor, i.e., security value.

Timing of the determination of the discount rate

The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease. This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental borrowing rate or the rate implicit in the lease. In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as Ind AS 116 requires a lessee to measure the right-of-use asset at the commencement date. The applicable discount rate is a component of the measurement of the lease; therefore, it is determined at the same time as other components of the measurement of the lease.

Concluding remarks

Ind AS 116 can turn out to be overly complex for certain corporates, especially those with a large number of leases. As highlighted above, there are significant judgements required relating to identifying the lease, determining the lease term and the discount rate while applying the requirements of Ind AS 116, which could have a significant impact on the balance sheet and the profit and loss.



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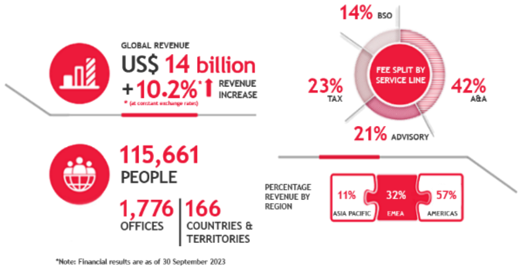

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