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Ind AS 116, *Leases*

Impact on the technology sector

22 August 2019

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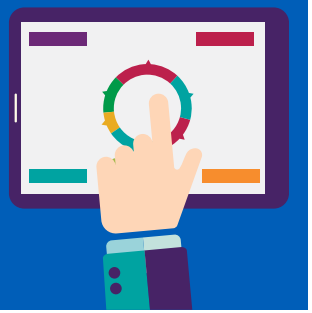
Welcome

01 Series of knowledge sharing calls

02 Covering current and emerging reporting issues



03 Scheduled towards the end of each month

04 Look out for our Accounting and Auditing Update, First Notes and Voices on Reporting publications

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Ind AS 116 – Quick recap

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Ind AS 116 - Quick recap

Leases on balance sheet

Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease payments

Profit/loss

Lease expense components:

Depreciation + Interest

= Total lease expense

Ind AS 116 eliminates the current operating/finance lease dual accounting model for lessees.

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Emerging and practical challenges - Transition

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Common transition approaches

Many companies in the technology sector have adopted the modified retrospective method to transition to Ind AS 116. Within this transition approach, companies have followed either of the following approaches to measure the Right-Of-Use (ROU) asset:

- **Option 1:** As if Ind AS 116 had always been applied (but using the incremental borrowing rate at the date of initial application)
- **Option 2:** At an amount equal to the lease liability (subject to certain adjustments).

Question: Companies should consider the transition approach they would adopt. The choice has significant implication and affects collation of required data, IT systems and future profitability.

Would the choice of option be available on a lease by lease basis or for the company as a whole?

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Deferred tax implications

- Company A transitions to Ind AS 116 with effect from 1 April 2019, using the modified retrospective method. It measures the ROU based on option 1 i.e. as though Ind AS 116 was always applied.
- Based on the above approach, company A records a ROU asset of INR5,000 million and a lease liability of INR6,000 million.
- In the jurisdiction in which company A operates, expenses are allowed as a deduction from taxable income for tax purposes based on actual payments i.e. depreciation of the ROU and interest expense on the lease liability are not considered to be allowable expenses.

Question: On the transition date, to the extent of the difference between the ROU and lease liability, would company A have to record any deferred taxes?

If yes, where should such deferred taxes be accounted for?

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Rent equalisation/deferred rent

- Company A transitions to Ind AS 116 with effect from 1 April 2019. For periods upto 31 March 2019, company A has recognised rental expenses under operating lease arrangements on a straight-line basis and recorded a rent equalisation reserve of INR10 million.
- In line with the requirements of Ind AS 109, *Financial Instruments*, company A had discounted the security deposits given to lessors and accounted for the difference between cash outflows and present value of security deposits, as deferred rent. As at 31 March 2019, company A carried a deferred rent of INR15 million in its balance sheet.

Question: On transition to Ind AS 116 and going forward, how would company A account for the rent equalisation reserve and deferred rent?

Would the answer differ if company A was to apply the practical expedient in relation to measurement of the ROU asset?

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Low value assets

- Ind AS 116 provides a recognition exemption for leases where the underlying asset is of **'low value'.** The exemption is available irrespective of the transition method adopted and can be applied on a lease by lease basis.
- Para B5 of Ind AS 116 states as follows:

  An underlying asset can be of low value only if:

  – The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee and

  – The underlying asset is not highly dependent on, or highly interrelated with, other assets.

Question: Is there a quantifiable threshold below which assets can be deemed to be of low value?

Should the asset be 'low value' on the date of transition or on the initial date when the lease arrangement was entered into?

Are companies required to compute the total of 'low value' assets and assess if these are material to the financial statements?

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Emerging and practical challenges – Lease term

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Assessment of insignificant penalty/termination rights

- Company A has entered into a lease arrangement for its office premises. Key particulars of the lease agreement are as follows:
  - Lease commencement date: 1 December 2018
  - Lease term: Five years
  - Non-cancellable lease term: Six months
  - Termination rights: After the non-cancellable lease term, the lessor and company A have a unilateral right to terminate the contract for convenience
  - Termination penalty: One month's rental
  - Expenditure incurred by company A on leasehold improvements: INR50 million
  - Useful life of leasehold improvements: Four years.
- Para B34 of Ind AS 116 states as follows:

  A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

Question: Should company A consider the lessor's termination right while determining the lease term? How is lessee's termination right evaluated while determining the lease term?

Can the value of leasehold improvements be considered while evaluating 'insignificant penalty'?

Basis above assessment, would the period of security deposits and useful life of leasehold improvements change?

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Emerging and practical challenges – Lease payments

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Lease payments during renewal term, non-lease components

Company A has entered into a lease arrangement for its office premises. Key particulars of the lease agreement are as follows:

- Lease commencement date: 1 December 2018
- Lease term: Five years
- Fixed lease payments during the initial lease term: INR1 million per month. In addition to this, company A is also required to pay property taxes, insurance and indirect taxes such as VAT or GST
- Maintenance fees: INR0.1 million per month
- Annual escalation: Fixed at five per cent per annum (general inflation adjusted in the market in which the lessor and lessee operate)
- Renewal: Company A has the right to renew the lease for an additional term of one year each
- Lease payments during the renewal term: Not defined in the lease agreement, subject to mutual agreement with lessor
- Lease term for Ind AS 116 purposes: Company A concludes the lease term to be eight years, as it is reasonably certain to renew the lease for an additional term of three years.

Question: Are maintenance charges required to be considered as lease payments?

In the absence of contractually agreed lease payments during the renewal term, what lease payments should company A consider while computing the ROU/lease liability?

Are property taxes, insurance and other indirect taxes part of lease payments for the purposes of Ind AS 116?

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Emerging and practical challenges – Discount rates

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Essentials of an appropriate discount rate

- Company A enters into a lease arrangement. Key facts are as follows:
  - Lease commencement date: 1 December 2018
  - Lease term: Five years
  - Fixed lease payments during the initial lease term: USD1 million per month
  - Underlying lease asset: Contract manufacturing facility
  - Company A's functional currency: INR
- Company A is a subsidiary of company P. The incremental borrowing rate for company P is readily available for an asset similar to the underlying asset in the above lease.

Question: Can company A apply the discount rate determined by company P, assuming both companies have identical underlying assets?

If not, what are the essential components of the discount rate that company A should consider?

Is the lease liability a monetary liability? If yes, how should company A account for the foreign exchange gains/(losses) on restatement?

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Emerging and practical challenges – Others

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Balance sheet presentation

Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease payments

- Ind AS 116 requires lessees to disclose ROU either separately in the balance sheet or include the ROU assets in the same line item in which the corresponding underlying assets are presented, if they are owned and disclose which line items in the balance sheet include those ROU assets.
- Ind AS Schedule III requires finance lease obligations to be disclosed under borrowings. ICAI's guidance note on Ind AS has referred to appropriate regulatory authorities to provide guidance/clarification of presentation of lease liabilities.

Question: What is the general practice in relation to disclosure of ROU asset? In the absence of appropriate guidance, how should companies disclose lease liabilities in the balance sheet?

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Inter-company lease arrangements

Company A enters into a lease arrangement with company P, its parent company. Key facts are as follows:

- Lease commencement date: 1 December 2018
- Lease term: Five years
- Fixed lease payments during the initial lease term: USD1 million per month
- Underlying lease asset: Contract manufacturing facility
- Company A's functional currency: INR.

Question: How should the above lease arrangement be accounted for in the separate and consolidated financial statements of company P?

Will the above transaction eliminate in full, in the consolidated financial statements of company P?

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Q&A

Links to previous recordings of VOR

Month	Topics	Link
February 2019 (special session)	• Key Audit Matters and new standard on leases - Impact on technology sector	Click here
April 2019	• Key updates relating to the Companies Act, 2013 issued by MCA • Supreme Court ruling on applicability of Provident Fund (PF) contribution on allowances • SEBI amendments pursuant to Kotak Committee applicable from 1 April 2019 • Ind AS 116, *Leases* and amendments to other Ind ASs • New/revised Standards on Auditing (SAs).	Click here
May 2019 (special session)	• Uncertainty over income tax treatments and new standard on leases impact on life sciences sector	Click here
July 2019	• Brief overview of Ind AS 116, Leases transition options and considerations • Prudential framework for resolution of stressed assets • Over of the new guidance relating to uncertainty over income tax treatments • Important Ind AS implementation issues provided in the Ind AS Technical Facilitation Group (ITFG) Bulletin 19 and 20	Click here
August 2019 (special session)	• Prevention of insider trading and safeguarding of UPSI • Issuance of Differential Voting Rights (DVR) shares • Revised formats for compliance report on corporate governance	Click here

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Our publications

Accounting and Auditing Update

First Notes

Coming up next

New issue of:

- Accounting and Auditing Update
- First Notes
- Voices on Reporting - publication

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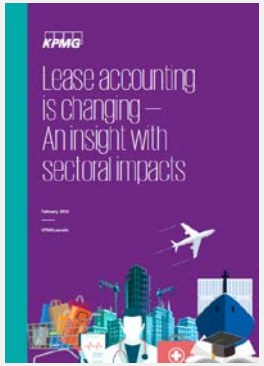
Lease accounting is changing- An insight with sectoral impacts



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Thank you

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