IND AS 116 LEASES

(This Indian Accounting Standard includes paragraphs set in bold type and plain type, which have equal authority. Paragraphs in bold type indicate the main principles.)

Objective

1. This Standard sets out the principles for the recognition, measurement, presentation and disclosure of *leases*. The objective 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 have on the financial position, financial performance and cash flows of an entity.

2. An entity shall consider the terms and conditions of *contracts* and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

Scope

3. An entity shall apply this Standard to all leases, including leases of *right-of-use assets* in a *sublease*, except for:

(*a*) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

(*b*) leases of biological assets within the scope of Ind AS 41 *Agriculture,* held by a lessee;

(*c*) service concession arrangements within the scope of Appendix D, *Service Concession Arrangements,* of Ind AS 115, *Revenue from Contracts with Customers*;

(*d*) licences of intellectual property granted by a lessor within the scope of Ind AS 115, *Revenue from Contracts with Customers*; and

(*e*) rights held by a lessee under licensing agreements within the scope of Ind AS 38, *Intangible Assets,* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Scope - Basis for Conclusion

[Based on Official Pronouncements of International Accounting Standard Board (IASB)]

It was decided that the scope of Ind AS 116 should be based on the scope of the leases requirements in Ind AS 17. Ind AS 17 applies to all leases, with specified exceptions.

Accordingly, Ind AS 116 contains scope exceptions for:

(*a*) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. Ind AS 116 Exploration for and Evaluation of Mineral Resources specifies the accounting for rights to explore for and evaluate mineral resources.

(*b*) leases of biological assets within the scope of Ind AS 41 Agriculture held by a lessee. Ind AS 41 specifies the accounting for biological assets, other than bearer plants, which are within the scope of Ind AS 16. Consequently, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of Ind AS 116.

(*c*) service concession arrangements within the scope of Ind AS 115.

(*d*) licences of intellectual property granted by a lessor within the scope of Ind AS 115. There are specific requirements relating to those licences within Ind AS 115.

(*e*) leases of intangible assets held by a lessee.

Service concession arrangements

It was decided to exclude from the scope of Ind AS 116 service concession arrangements within the scope of Ind AS 115. Consistently with the conclusions in Ind AS 115, any arrangement within its scope (i.e. that meets the conditions in paragraph 5 of Appendix D of Ind AS 115) does not meet the definition of a lease.

This is because the operator in a service concession arrangement does not have the right to control the use of the underlying asset. For this reason, it was considered whether it was necessary to explicitly exclude from the scope of Ind AS 116 service concession arrangements within the scope of Ind AS 115. However, such a scope exclusion had been included in Determining whether an Arrangement contains a Lease (earlier Appendix C of Ind AS 17), and stakeholders informed that including a scope exclusion for service concession arrangements in Ind AS 116 would provide clarity in this respect.

Intangible assets

Ind AS 116 excludes from its scope rights held by a lessee under licensing agreements within the scope of Ind AS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This is because these licensing agreements are accounted for applying Ind AS 38.

Ind AS 116 also states that a lessee may, but is not required to, apply Ind AS 116 to leases of other intangible assets. The intention was not want to prevent a lessee from applying Ind AS 116 to leases of intangible assets for which there are no specific requirements in other Standards. It was acknowledged that there is no conceptual basis for excluding leases of intangible assets from the scope of Ind AS 116 for lessees. However, it was concluded that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for applying the requirements of Ind AS 116. Many stakeholders agreed with this approach.

Onerous contracts

It was decided not to specify any particular requirements in Ind AS 116 for onerous contracts. This decision was made because:

(*a*) for leases that have already commenced, no requirements are necessary. After the commencement date, an entity will appropriately reflect an onerous lease contract by applying the requirements of Ind AS 116. For example, a lessee will determine and recognise any impairment of right-of-use assets applying Ind AS 36 Impairment of Assets.

(*b*) for leases that have not already commenced, the requirements for onerous contracts in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets are sufficient. The requirements in Ind AS 37 apply to any contract (and hence any lease contract) that meets the definition of an onerous contract in that Standard.

Subleases

It was decided that an entity should account for leases of right-of-use assets (i.e. subleases) in the same way as other leases. Accordingly, subleases are within the scope of Ind AS 116.

Inventory

Ind AS 116 does not specifically exclude leases of inventory from its scope. The term 'leased inventory' is sometimes used to describe purchases of non-depreciating spare parts, operating materials, and supplies that are associated with leasing another underlying asset. It was noted that few of these transactions, if any, would meet the definition of a lease because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business, or for consumption in the process of production for sale in the ordinary course of business. Accordingly, it was decided that a scope exclusion was not necessary.

Non-core assets

Information about assets that are not essential to the operations of an entity is sometimes of less interest to users of financial statements, because those assets are often less significant to the entity. Accordingly, some think that the costs associated with recognising and measuring the assets and liabilities arising from leases of non-core assets could outweigh the benefits to users. For example, information about assets and liabilities arising from leases of delivery vans is important to assess the operations of a delivery company, but it may not be important for materiality reasons in assessing the operations of a bank that uses vans to deliver supplies to its retail banking locations. Consequently, it was considered whether to exclude leases of non-core assets from Ind AS 116.

Although some favoured such an approach, it was noted that:

(*a*) defining 'core' and 'non-core' would be extremely difficult. For example, would office buildings used by a bank be a core asset, and would the conclusion be different if the bank has retail banking operations? Would an entity consider some offices or cars to be core assets and others non-core? If core assets were defined as those essential to the operations of an entity, it could be argued that every lease would be a lease of a core asset. Otherwise, why would an entity enter into the lease?

(*b*) different entities might interpret the meaning of non-core assets differently, thereby reducing comparability for users of financial statements.

(c) other Standards do not distinguish between core and non-core purchased assets. Because of this, it would be difficult to justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset.

Consequently, Ind AS 116 does not make any distinction in accounting on the basis of whether the underlying asset is core to an entity's operations.

Long-term leases of land

A long-term lease of land is sometimes regarded as being economically similar to the purchase of the land. Consequently, some stakeholders suggested that long-term leases of land should be excluded from the scope of Ind AS 116. However, it was decided not to specifically exclude such leases from the scope of Ind AS 116 because:

(*a*) there is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.

(*b*) for a long-term lease of land (for example, a 99-year lease), the present value of the lease payments is likely to represent substantially all of the fair value of the land. In this case, the accounting applied by the lessee will be similar to accounting for the purchase of the land. If the lessee obtains control of the land, it will account for the contract as the purchase of the land by applying Ind AS 16 Property, Plant and Equipment, rather than by applying Ind AS 116.

Leases of investment property at fair value

Considerations were made on whether leases of investment property measured at fair value should be excluded from the scope of Ind AS 116. Such an exclusion was considered because many users of the financial statements of investment property lessors informed that the requirements of Ind AS 40 *Investment Property* provide useful information about the leasing activities of a lessor, especially when the fair value model is used. However, it was concluded that a lessor of investment property should apply Ind AS 40 when accounting for its investment property and apply Ind AS 116 when accounting for the lease. That is similar to how Ind AS 17 and Ind AS 40 interacted. Accordingly, a user of financial statements would obtain fair value information about investment property subject to operating leases, which is required by Ind AS 40, and information about rental income earned by the lessor, which is required by Ind AS 116.

Embedded derivatives

It was decided to require an entity to separate from a lease any derivatives embedded in the lease (as defined in Ind AS 109 Financial Instruments), and account for the derivatives applying Ind AS 109. Nonetheless, Ind AS 116 includes specific requirements for features of a lease such as options and residual value guarantees that may meet the definition of a derivative. It was noted that the lease accounting model in Ind AS 116 was not developed with derivatives in mind and, thus, Ind AS 116 would not provide an appropriate basis on which to account for derivatives. Accordingly, if derivatives embedded in leases were not accounted for separately, unrelated derivative contracts could be bundled with leases to avoid measuring the derivatives at fair value.

4. A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3(e).

Recognition exemptions (paragraphs B3-B8)

5. A lessee may elect not to apply the requirements in paragraphs 22-49 to:

(*a*) *short-term leases;* and

(*b*) leases for which the *underlying asset* is of low value (as described in paragraphs B3-B8).

Recognition exemptions - Basis for Conclusion

[Based on Official Pronouncements of International Accounting Standard Board (IASB)]

Short-term leases

It was concluded that the benefits of requiring a lessee to apply all of the requirements in Ind AS 116 to short-term leases do not outweigh the associated costs. In considering how to reduce the costs for lessees, both the nature and the scope of a possible exemption were considered.

Nature of the exemption

Considerations were made for simplifying the measurement requirements for short-term leases. Specifically, considerations were made for exempting lessees from the requirement to discount the payments used to measure the assets and liabilities arising from short-term leases. Many stakeholders, however, thought that this exemption would provide insufficient cost relief for lessees because it would still require an entity to track a possibly large volume of leases of a low value.

It was concluded that, even with simplified measurement requirements, the benefits of requiring a lessee to recognise right-of-use assets and lease liabilities for short-term leases would not outweigh the associated costs. Consequently, paragraph 5(a) of Ind AS 116 permits a lessee to elect not to apply the recognition requirements to short-term leases. Instead, a lessee can recognise the lease payments associated with short-term leases as an expense over the lease term, typically on a straight-line basis. It was decided that this choice should be made by class of underlying asset.

In the light of the feedback that an exemption for short-term leases did not provide sufficient relief for leases of low-value assets, a separate exemption for those leases was developed.

Definition of 'short-term'

It was considered to define a short-term lease as a lease that, at the commencement date, has a maximum possible term of 12 months or less. However, many thought that a short-term lease exemption defined in this way would provide limited cost relief for lessees. It was noted that, practically, a lease rarely has a maximum possible term of 12 months or less. For example, some suggested that many leases that run month-to-month would not qualify for the exemption.

In the light of these, it was considered to expand the short-term lease exemption to leases of more than 12 months. Some had suggested that 'short-term' should be up to five years. However, this approach was not adopted because, for example, three-year leases are more likely to give rise to material assets and liabilities than 12 month leases, and the objective of the standard was to ensure greater transparency about an entity's leasing activities.

Instead, it was decided to expand the short-term lease exemption by making the determination of duration of short-term leases consistent with the determination of lease term, thus considering the likelihood of extension options being exercised or termination options not being exercised. Accordingly, Ind AS 116 defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less.

In reaching this decision, there was a risk that leases could be structured to meet the short-term lease exemption. It was concluded that this risk is mitigated by the economic consequences of a short-term lease for a lessor. There would often be an economic disincentive for lessors to grant shorter term leases, because shortening the lease term would increase the risk associated with a lessor's residual interest in the underlying asset. Consequently, the view was that a lessor would often either demand increased lease payments from the lessee to compensate for this change in risk or refuse to shorten the non-cancellable period of the lease. In addition, it was noted the rigour that lessees are expected to apply when determining the lease term, as described in paragraphs B37-B40 of Ind AS 116. This should reduce the risk of non-substantive break clauses being inserted within contracts solely for accounting purposes. It was also decided that a lessee should reassess the lease term of a short-term lease by treating it as a new lease if that lease term changes.

It was observed that little incremental information would be lost by defining short-term leases by reference to the Ind AS 116 determination of lease term, instead of the maximum possible term. That is because a lessee would include only lease payments for the duration of the lease term as an asset and a liability, irrespective of the maximum possible term. For example, for a lease with an extension option after six months which the lessee is not reasonably certain to exercise, the lease term is six months. If that lease were not captured by the short-term lease exemption (because the maximum term is longer than the lease term), the lessee would include only lease payments for the six-month lease term in measuring the asset and liability. Consequently, by aligning the determination of short-term with the determination of lease term, the only incremental change in information would be that the lessee would no longer reflect the six months of lease payments on its balance sheet.

It was also considered whether identifying short-term leases using the Ind AS 116 determination of lease term would be more complex to apply, because more judgement would be needed to identify that lease term than the maximum term. However, on the basis of feedback received, it was concluded that any additional complexity in determining the lease term would be more than compensated for by the additional cost relief provided overall as a result of:

(*a*) applying the exemption to a wider group of leases; and

(*b*) requiring lessees to perform only one assessment of lease term for the purposes of both identifying whether the lease is a short-term lease and measuring the assets and liabilities for leases that are not short-term.

It was also decided to require a lessee to disclose the expense related to short-term leases for which the lessee has elected to apply the short-term lease exemption (see paragraph 53(c) of Ind AS 116). This disclosure provides useful information to users of financial statements about the lease payments that are excluded from lease liabilities as a consequence of the short-term lease exemption.

Leases of low-value assets

As noted in paragraphs above, many lessees expressed concerns about the costs of applying the requirements of Ind AS 116 to leases that are large in number but low in value. Many suggested that such an exercise would require a significant amount of effort with potentially little effect on reported information.

In the light of these concerns, it was decided to provide a recognition exemption for leases of low-value assets. Consequently, Ind AS 116 permits a lessee to elect, on a lease-by-lease basis, not to apply the recognition requirements of Ind AS 116 to leases for which the underlying asset is of low value.

In developing the exemption, an attempt was made to provide substantive relief to preparers while retaining the benefits of the requirements in Ind AS 116 for users of financial statements. The intention of exemption was to apply to leases for which the underlying asset, when new, is of low value (such as leases of tablet and personal computers, small items of office furniture and telephones). At the time of making decisions previously, the view was regarding leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less. A lease will not qualify for the exemption if the nature of the underlying asset is such that, when new, its value is typically not low. It was also decided that the outcome of the assessment of whether an underlying asset is of low value should not be affected by the size, nature, or circumstances of the lessee - i.e. the exemption is based on the value, when new, of the asset being leased; it is not based on the size or nature of the entity that leases the asset.

Fieldwork was conducted to assess the effect that low-value asset leases would have if the right-of-use assets and lease liabilities were recognised in the financial statements of lessees. On the basis of this fieldwork, it was observed that, in most cases, assets and liabilities arising from leases within the scope of the exemption would not be material, even in aggregate. Consideration was whether these findings demonstrated that the exemption would be of limited benefit to lessees because most leases that would be within its scope might instead be excluded from the recognition requirements of Ind AS 116 by applying the concept of materiality in the Conceptual Framework and in Ind AS 1. However, in the light of feedback received from preparers of financial statements, it was concluded that the exemption would provide substantial cost relief to many lessees (and, in particular, smaller entities) by removing the burden of justifying that such leases would not be material in the aggregate.

The risk was that the aggregate value of leases captured by the exemption might be material in some cases. Fieldwork suggested that the aggregate value is most likely to be material for large assets made up of a number of individual leases of low-value assets (such as IT equipment made up of individually low-value component parts). Consequently, it was decided that if an underlying asset is highly dependent on, or highly interrelated with, other underlying assets, a lessee should not apply the recognition exemption to the lease of that individual asset. Similarly, it was decided that a lessee should not apply the recognition exemption to a lease of an underlying asset if the lessee cannot benefit from that underlying asset on its own or together with other readily available resources, irrespective of the value of that underlying asset.

It was decided that the recognition exemption for leases of low-value assets should be applied on a lease-by-lease basis. A requirement to apply the exemption by class of underlying asset, instead of lease-by-lease, would have introduced a burden on lessees to assess every individual asset within a class. Consequently, the recognition exemption for leases of low-value assets will be easier to apply, and of more benefit to lessees, if applied on a lease-by-lease basis.

It was also decided to require a lessee to disclose the amount of the expense recognised related to leases of low-value assets for which the lessee has elected to apply the recognition exemption (see paragraph 53(d) of Ind AS 116). This disclosure provides useful information to users of financial statements about the amount of lease payments that are excluded from lease liabilities as a consequence of a lessee applying the exemption relating to leases of low-value assets.

Illustrative Example

[Based on Official Pronouncements of International Accounting Standard Board (IASB)]

Example - Truck rental

Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the contract is permitted to be transported on this truck for the period of the contract. The contract specifies a maximum distance that the truck can be driven. Customer is able to choose the details of the journey (speed, route, rest stops, etc.) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete.

The cargo to be transported, and the timing and location of pick-up in New York and delivery in San Francisco, are specified in the contract.

Customer is responsible for driving the truck from New York to San Francisco.

The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.

Customer has the right to control the use of the truck throughout the period of use because: