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Insights into Ind AS 116: A series

IFRS 16 represents the first major overhaul of lease accounting in over 30 years. The Ministry of Corporate Affairs has now notified 1 April 2019 as the day from which the corresponding Ind AS 116 becomes applicable. The new Standard will affect most companies that are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high-value equipment. This is the first in a series of six articles on this topic.

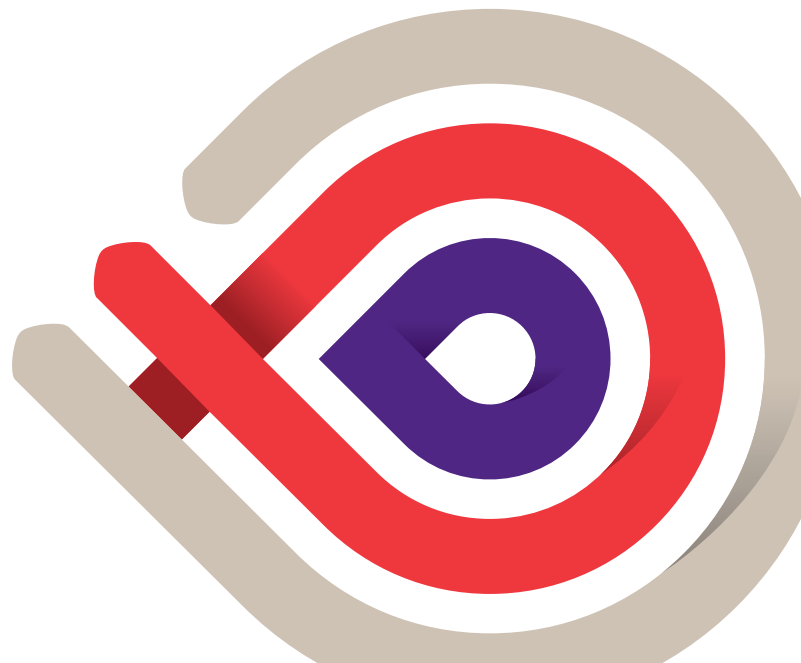
Definition of a lease

Since accounting for leases under Ind AS 116 results in substantially all leases being recognised on a lessee's balance sheet, the evaluation of whether a contract is (or contains) a lease becomes even more important than it is under Ind AS 17 including Appendix C to Ind AS 17. In practice, the main impact will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on Appendix C; however, Ind AS 116 replaces Appendix C guidance with new guidance that differs in some important respects.

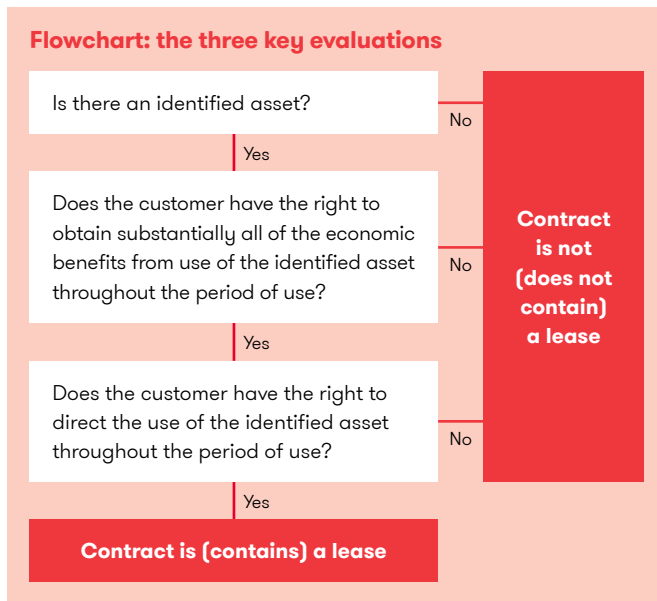
Ind AS 116 changes the definition of a lease and provides guidance on how to apply this new definition. As a result, some contracts that do not contain a lease today will meet the definition of a lease under Ind AS 116, and vice versa.

Under Ind AS 116 a lease is defined as “a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”

A contract can be (or contain) a lease only if the underlying asset is 'identified'. Having the right to control the use of an identified asset means having the right to direct, and obtain all of the economic benefits from, the use of that asset. These rights must be in place for a period of time, which may also be determined by a specified amount of use. Put simply, if the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way it makes decisions about the use of assets it owns outright. In such cases, the customer (ie the lessee) is required to recognise these rights on its balance sheet as a 'right-of-use asset'. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service and so there is no right-of-use asset to recognise.



Applying the new definition involves three key evaluations, all of which must be met in order to conclude that a contract is or contains a lease. These evaluations are summarised in the following flowchart:



Let's examine each of these in more detail.

Is there an identified asset?

An identified asset is an asset that is either:

- explicitly identified in the contract, or
- is implicitly specified by being identified at the time that the asset is made available for use by the customer.

Even if an asset is explicitly specified, a customer does not have the right to use an identified asset if the supplier has a **substantive substitution right** throughout the period of use.

What is a substantive substitution right?

A substantive substitution right exists if the supplier has the practical ability to substitute alternative assets throughout the period of use and the economic benefits of substituting the asset would exceed the cost (or in other words, the supplier would benefit economically from substituting the asset). When the asset is located at the customer's premises, the costs associated with substituting the asset are likely to be higher, making it less likely that the supplier would economically benefit from making a substitution.

The assessment of whether a supplier's substitution right is substantive is based on facts and circumstances present at inception of the contract. This means that the customer ignores events that are not likely to occur in future such as:

- an agreement by a future customer to pay an above-market rate for use of the asset
- the introduction of new technology that is not substantially developed at the inception of the contract
- a substantial difference between the performance or customer's use of an asset, and the use or performance considered likely at the inception of the contract, and

- a substantial difference between the actual market price of the asset during the period of use, and the market price considered likely at the inception of the contract (Ind AS 116.B16).

If the supplier has the right or obligation to substitute the asset for repair purposes or to provide routine maintenance services (eg, to allow it to install a technical upgrade that has become available), a customer is not precluded from having the right to use an identified asset. A customer is also not required to perform an exhaustive search to determine if a supplier has a substantive substitution right. If a customer cannot readily determine whether a supplier has such a right, it may conclude that a right does not exist.

Example 1 – Rail cars

In a contract between a customer and a supplier, the supplier needs to transport goods using a particular type of rail car in line with a specified timetable over a three-year period. The timetable and quantity of goods stipulated are equivalent to the customer having the use of six rail cars for three years. The supplier makes available the cars, driver and engines as part of the arrangement. The supplier has a large supply of similar cars and engines that are available to fulfil the obligations of the arrangement. The rail cars and engines are kept at the supplier's premises when they are not being used to transport the goods.

Analysis

The contract does not contain a lease of either rail cars or engines.

The rail cars and engines used to transport the customer's goods are not identified assets. The supplier has a substantive substitution right to replace the rail cars and engines as a result of:

- the supplier having the practical ability to substitute each car and engine throughout the period of use. Alternative cars and engines are readily available to the supplier and these can be substituted without the customer's approval, and
- the supplier being able to economically benefit from substituting each car and engine. There would be very little cost associated with substituting these assets as the cars and engines are stored at the supplier's premises and the supplier has a large pool of similar cars and engines.

Therefore, the customer does not have the right to obtain substantially all of the economic benefits from the use of an identified rail car or an engine or directs their use. The supplier chooses which rail cars and engines are used for each delivery and therefore directs them. It has substantially all of the economic benefits from use of the rail cars and engines.

Can a portion of an asset be an identified asset?

A portion of an asset is an identified asset if it is physically distinct (eg a single floor of an apartment building). Where a portion of an asset is not physically distinct (eg 20% of the capacity of an oil pipeline), the portion of the asset is not an identified asset unless it represents substantially all of the capacity of the asset. If neither of these situations exists, the customer is not provided with the right to obtain substantially all the economic benefits from the use of the asset and an identified asset does not exist.

Example 2 - Fibre-optic cable

A customer enters into a 10-year contract with a utilities company (the supplier) for the right to use five individually specified, physically distinct fibre-optic strands (fibres) within a larger cable running between New York and London. The customer makes all relevant decisions concerning the use of the individual fibres by connecting them to its own electronic equipment (ie, the customer 'lights' the fibres) and deciding what data, and how much data, each strand will carry. If any of the strands are damaged, the supplier is responsible for effecting any necessary repairs. The supplier owns additional fibres both within the same cable and in adjacent cables but can only substitute those for the customer's strands when performing ongoing maintenance or effecting necessary repairs.

Analysis

The contract represents a lease of unlit fibre-optic strands (the identified assets).

The fibre optic strands are identified assets because they are explicitly specified in the contract and are physically distinct from other fibres within the cable. The supplier cannot substitute the fibres for reasons other than repair, maintenance or malfunction.

Conversely, if the customer was entitled only to use an amount of capacity equivalent to five fibres within a cable made up of 15 strands, but not five specific strands, the contract would contain neither an identified asset nor a lease because the capacity represented by five fibres does not represent substantially all the capacity of the 15-strand cable. In this case, the supplier would only be providing data capacity (ie, a service).

Does the customer have the right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use?

The second evaluation involves determining whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use. There are many ways that a customer can obtain those economic benefits such as by using, holding or sub-leasing the asset.

When making this evaluation, a customer considers his/her rights within the defined scope of the contract. For example, if a contract specifies that a customer can only print up to a specified number of pages during the period of use of a printer, the customer considers only the economic benefits arising from use of the printer for those pages, and not beyond.

Variable lease payments based on the customer's use of the asset (eg variable payments based on sales) do not prevent a customer from obtaining substantially all of the economic benefits from the use of the asset. Although the customer passes on some of the benefits to the supplier through variable payments, the customer is still the party that receives the economic benefits arising from use of the asset (in this case, the cash flows arising from the sales). Ind AS 116 is explicit on this point to eliminate the possibility that companies might include variable lease payments solely to avoid the arrangement being classified as a lease and therefore lease accounting.

Does the customer have the right to direct the use of the identified asset throughout the period of use?

In evaluating whether the customer has the right to direct the use of an identified asset, this customer must have the right to direct 'how and for what purpose' the asset is used throughout the period of use. In making this evaluation, a customer considers the decisions that most directly impact the economic benefits to be derived from the use of the asset, including:

- rights to decide the type of output to be produced by the asset(s);
- rights to decide when the output is produced;
- rights to decide where the output is produced; and
- rights to decide whether the output is produced and the quantity thereof.

In many cases, contracts will include terms and conditions that protect the supplier's interest in the asset, protect its personnel and/or ensure the supplier complies with laws and regulations. These rights are considered to be protective and do not, in isolation, prevent the customer from having the right to direct the use of the asset within the scope of the contract.

Examples of protective rights noted in Ind AS 116 include:

- specifying the maximum amount of use of an asset (eg an aircraft lease with a maximum usage allowed of 15,000 engine hours per year)
- limiting where or when the customer can use the asset (eg an automotive lease specifying that the identified vehicle can only be driven in France)
- requiring the customer to follow certain operating practices (eg a lease of retail space where opening hours are limited to specific times of the day)
- requiring the customer to notify the supplier if the customer changes how the asset will be used (eg a warehouse lease where the customer must notify the supplier if they plan to change the use of the space from storing inventory to a retail area).

Lastly, Ind AS 116 is clear that rights to operate or maintain an asset do not give a customer the right to direct how and for what purpose the asset is used, except for when the 'how and for what purpose' decisions are predetermined. In this case, the customer will control the asset if the customer has the right to operate the asset throughout the period of use or the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Example 3 – Ship

A customer enters into a contract with a shipping company (the supplier) to transport cars from India to Singapore. The contract specifies the particular ship to be used, the dates of pick-up and delivery, and the cars to be transported (which will occupy the full capacity of the ship). The supplier operates and maintains the ship and is responsible for the safe passage of the cars. The customer is not able to make changes (ie to either the destination or the nature of the cargo) once the contract has been signed.

Analysis

The contract does not contain a lease.

After signing the contract, the customer is not able to direct how and for what purpose the ship is used and does not therefore control the use of the asset. The contract pre-determines how and for what purpose the ship will be used and customer neither operates nor designed the ship.

Transition considerations

On transition to Ind AS 116, both lessees and lessors can choose whether to apply the new lease definition to all of their contracts or apply transitional relief from reassessing whether contracts in place at the date of initial application are, or contain, a lease. If an entity chooses to apply this relief, then the new lease definition will be applied to contracts entered into or modified on or after the date of initial application. **The next article in this series will explore various transition options available to entities under this Standard.**

Contact us

To know more, please visit www.grantthornton.in or contact any of our offices as mentioned below:

NEW DELHI

National Office
Outer Circle
L-41 Connaught Circus
New Delhi 110001
T +91 11 4278 7070

NEW DELHI

6th floor
Worldmark 2
Aerocity
New Delhi 110037
T +91 11 4952 7400

AHMEDABAD

7th Floor,
Heritage Chambers,
Nr. Azad Society,
Nehru Nagar,
Ahmedabad - 380015

BENGALURU

5th Floor, 65/2, Block A,
Bagmane Tridib, Bagmane
Tech Park, C V Raman Nagar,
Bengaluru - 560093
T +91 80 4243 0700

CHANDIGARH

B-406A, 4th Floor
L&T Elante Office Building
Industrial Area Phase I
Chandigarh 160002
T +91 172 4338 000

CHENNAI

7th Floor, Prestige Polygon
471, Anna Salai, Teynampet
Chennai - 600 018
T +91 44 4294 0000

DEHRADUN

Suite no. 2211, 2nd floor Building
2000, Michigan Avenue,
Doon Express Business Park
Subhash Nagar, Dehradun - 248002
T +91 135 2646 500

GURGAON

21st Floor, DLF Square
Jacaranda Marg
DLF Phase II
Gurgaon 122002
T +91 124 462 8000

HYDERABAD

7th Floor, Block III
White House
Kundan Bagh, Begumpet
Hyderabad 500016
T +91 40 6630 8200

KOCHI

6th Floor, Modayil Centre point
Warriam road junction
M. G. Road
Kochi 682016
T +91 484 406 4541

KOLKATA

10C Hungerford Street
5th Floor
Kolkata 700017
T +91 33 4050 8000

MUMBAI

16th Floor, Tower II
Indiabulls Finance Centre
SB Marg, Elphinstone (W)
Mumbai 400013
T +91 22 6626 2600

MUMBAI

9th Floor, Classic Pentagon
Nr Bisleri factory, Western
Express Highway, Andheri (E)
Mumbai 400099
T +91 22 6176 7800

NOIDA

Plot No. 19A, 7th Floor
Sector - 16A
Noida 201301
T +91 120 485 5900

PUNE

3rd Floor, Unit No 309 to 312
West Wing, Nyati Unitree
Nagar Road, Yerwada
Pune- 411006
T +91 20 6744 8800

For more information or for any queries, write to us at contact@in.gt.com



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