Deloitte.

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Tracking IFRS
Exposure draft on Leases

1. Introduction

On 17 August 2010, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued an exposure draft (ED) on "Leases". The project was undertaken to address the limitations of existing accounting models based on classification of leases. The joint ED will also help in achieving convergence between the International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (US GAAP).

The exposure draft proposes significant changes to the accounting for leases. The ED issued by IASB proposes to replace the existing guidance on accounting for leases and will supersede the following IFRSs:

- IAS 17 *Leases*
- IFRIC 4 *Determining whether an Arrangement contains a Lease*
- SIC 15 *Operating Leases - Incentives*
- SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

The ED is due for comments by 15 December 2010 and is expected to be issued as a final standard in mid-2011. The ED does not specify an effective date or whether early adoption will be permitted.

2. Why is it important for you ?

Leasing is an important source of finance, and leasing transactions are pervasive in all forms and sizes of businesses. A change in the accounting for leases will affect many entities. The ED proposes significant changes to accounting by both lessees and lessors. The ED proposes a right-of-use approach for accounting for leases instead of existing accounting based on classification of leases. The proposals in the ED will have a greater impact on the accounting for transactions presently classified as operating leases and get accounted for using an 'off-balance sheet' accounting model. This is because, under the ED, the assets and liabilities resulting from such lease transactions will be required to be recognized in the financial statements. The ED also proposes certain changes to the accounting for transactions presently classified and accounted for as finance leases.

This edition of Tracking IFRS contains only preliminary understanding and observations on the ED and should not be relied upon for complete knowledge of the subject. Kindly visit www.iasb.org for full text of the ED

Entities in India will transition to the Indian accounting standards converged with the IFRSs from 1 April 2011 onwards. If the effective date is shortly after the final standard is issued or close to the convergence date, it may be useful to evaluate the proposals in this ED and assess the implications. The first-time adopters may find it more beneficial to early adopt the standard (if permitted) to adapt systems and processes to the new requirements and avoid significant changes soon after transition to IFRS. This edition of Tracking IFRS contains only preliminary understanding and observations on the ED and should not be relied upon for complete knowledge of the subject. Kindly visit www.iasb.org for full text of the ED.

3. Scope of the proposed standard

The ED will apply to all leases, including subleases, except:

Leases of intangible assets, natural resources, biological assets, etc.

The ED does not apply to the leases of intangible assets. Other contracts not within the scope of the ED are leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources and leases of biological assets.

Leases which have not commenced and are onerous

The ED proposes that leases during the period between the date of inception and the date of commencement of a lease if they meet the definition of an onerous contract shall be outside the scope of the standard and shall be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* After the commencement, such contracts shall be accounted for in accordance with the ED.

The date of inception of the lease is defined in the ED *as the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement.* The date of commencement of lease is defined in the ED *as the date on which the lessor makes the underlying asset available for use by the lessee.*

Leases of investment property

A lessee of an investment property that elects to measure the property at fair value under IAS 40 *Investment Property* would measure the right-of-use asset in accordance with IAS 40 after initial recognition. Changes in the liability to make lease payments after initial recognition would be recognized in profit or loss in accordance with IAS 40.

Further, a lessor that leases investment property to others would not apply the proposals if the lessor elects to measure the property at fair value in accordance with IAS 40. For lessors that use the fair value model, the ED proposes to amend IAS 40 to require income on investment property to be recognized on a straight-line basis over the lease term.

Contracts which represent a purchase or sale of an underlying asset

A contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity are outside the scope of the ED.

4. Certain key definitions

Lease

Lease is defined as *a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.* The contracts which do no take the legal form of lease but are dependent on the use of a specified asset and convey a right to use the asset are also within the purview of the ED and will be accounted for as leases (refer point 7.5 below).

Indian context

The definition of leases under the ED is similar to the definition under AS 19 *Leases.* However, the proposed guidance may still have an impact on the accounting for certain service contracts. This is because, presently under Indian GAAP, the requirement for operating leases to recognize expense over the term of the lease and recording for service contracts has a similar financial effect; and the separation of the service component and the lease component may not necessarily have resulted in an accounting impact. However, an assessment and identification of leases (even in the nature of operating leases) contained in service contracts will become critical as the ED proposes significant changes to accounting for leases presently classified as operating leases.

For example, consider an arrangement to rent office space that also includes housekeeping, maintenance and security services in return for fixed lumpsum monthly payments. Assuming that the arrangement is in the nature of a straight-forward operating lease (without any escalation clauses, etc.), under the existing IFRS, the monthly payments for the space and the services would be accounted for in the profit or loss on a monthly basis.

However, under the ED, in the aforesaid example, the payments towards the rent of office space and payments for ancillary services may have to be bifurc-ated.The rental payments will be accounted for using the righ of use approach proposed in the ED and will result in an amortization expense and interest income, while the payment for services will be accounted in the profit or loss. This will result in a change in the timing, pattern and nature of items recognized in the financial statements.

The aforesaid observation shall also be applicable in the context of lessors. Also, refer 7.1 below.

Example 1

An entity may have a lease that has a non-cancellable 2-year term, an option to renew for 1 year at the end of 2 years, and an option to renew for an additional 1 year at the end of 3 years. Assume that the entity determines the probability for each term as follows:

- 40 per cent probability of 2-year term
- 30 per cent probability of 3-year term
- 30 per cent probability of 4-year term

	Two 1-year renewals	One 1-year renewal	No renewal
Lease term	4 years	3 years	2 years
Probability	30%	30%	40%
Cumulative probability	30%	60%	100%

The term will be at least 2 years; there is a 60 per cent chance that the term will be 3 years or longer, but only a 30 per cent chance that the term will be 4 years. Therefore there is a 60 per cent chance that the term will be 3 years, which is the longest possible term more likely than not to occur. Therefore the lease term is 3 years.

Lessee

An entity that enters into a contract to provide another entity with consideration in return for the right to use an asset for a period of time.

Lessor

An entity that enters into a contract to provide another entity with the right to use an asset for a period of time in return for consideration.

Lease term

Lease term is deifned as *the longest possible term that is more likely than not to occur.* Lease term shall be determined by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease. Refer example 1 above.

Indian context

Presently under the Indian GAAP, lease term includes the non-cancellable period plus renewal period which are reasonably certain to be excersied. 'Reasonable certainty' generally interpreted, has a high threshold. However, as proposed by the ED, the lease term shall be the expected lease term estimated by considering the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease. The new guidance under the ED may result in determination of a different lease term and consequently will have an accounting impact.

Lease payments

Lease payments are defined as *payments arising under a lease including fixed rentals and rentals subject to uncertainty, including, but not limited to, contingent rentals and amounts payable by the lessee under residual value guarantees and term option penalties.*

However, the exercise price of a purchase option included in a lease is not a lease payment and the purchase option is not included in determining the present value of lease payments payable.

Indian context

The inclusion of contingent rentals using an expected outcome approach would represent a significant change from the existing lease accounting model under Indian GAAP that excludes contingent rentals from minimum lease payments. The need to develop scenarios and probabilities, based on information that could differ from lease to lease, together with the need to reassess the estimate (discussed later) may make this requirement onerous for many Indian companies.

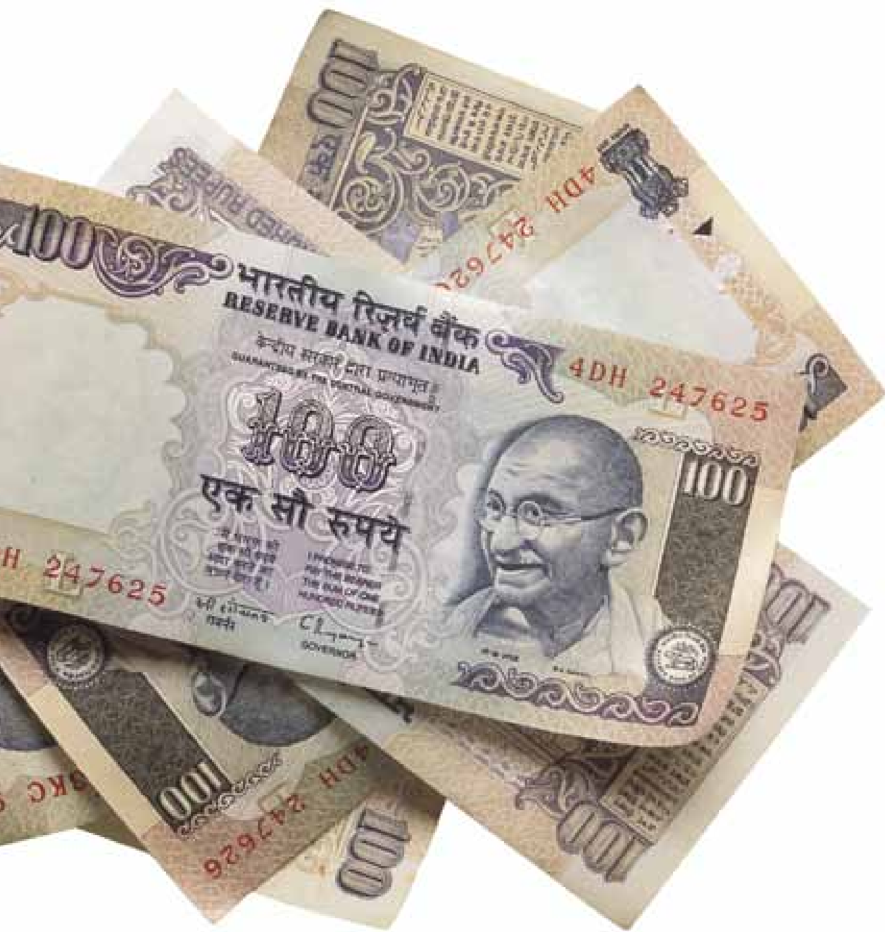
5. Accounting by lessees

Under the ED, accounting for leases by lessees is based on the right-of-use approach. This is based on the premise that in a lease arrangement, a lesee acquires a right to use, or control the use of, a specified asset in return for a series of payments. The accounting proposed by the ED aims to recognize the inherent asset and liability resulting from the economics of the transaction.

5.1. Initial recognition and measurement

Liability to make lease payments

The ED requires that at the date of commencement of a lease, a lessee shall recognize in the statement of financial position a 'liability to make lease payments' equal to the present value of the total lease payments.



The ED specifies that the present value of lease payments payable during the lease term shall be the probability-weighted average of the cash flows for a reasonable number of outcomes.

Right-of-use asset

The ED requires that the lessee shall also recognize an asset representing the lessee's right to use, or control the use of, a specified asset for the lease term, termed as the 'right-of-use asset'. The right-of-use asset shall be measured at the amount of the liability to make lease payments (as caluculated in Example 2), plus any initial direct costs incurred by the lessee.

Irrespective of the type of lease, operating or financial, the ED proposes one single model of accounting by lessees for all leases

Example 2

Continuing from example 1, let us assume that the annual lease payments are ₹100,000 plus a contingent rent of 1% of gross sales:

	Outcome 1 Sales growth: Nil	Outcome 2 Sales growth: 5%pa	Outcome 3 Sales growth 10%pa	Outcome 4 Sales decline 5%pa
Sales over 3 years, assuming ₹1,000,000 in year 1	₹ 3,000,000	₹ 3,152,500	₹ 3,310,000	₹ 2,852,500
Contingent rents	₹ 30,000	₹ 31,525	₹ 33,100	₹ 28,525
Present value of contingent rents*	₹ 25,771	₹ 27,013	₹ 28,295	₹ 24,568
Annual contractual rents	₹ 100,000	₹ 100,000	₹ 100,000	₹ 100,000
Present value of contingent rents*	₹ 257,710	₹ 257,710	₹ 257,710	₹ 257,710
Sum of present values	₹ 283,481	₹ 284,723	₹ 286,005	₹ 282,278
Probability	15%	30%	50%	5%
Probability-weighted amounts (a)	₹ 42,522	₹ 85,417	₹ 143,003	₹ 14,114

* Assuming lessee's incremental borrowing rate used for discounting is 8%.

Thus, the liability to make lease payments shall be initially recognized at ₹ 285,055 being the sum total of probability-weighted cash flows (∑a).

Example 3

Continuing from example 2, if initial direct costs amounted to ₹ 5,000, the right-of-use asset shall be initially recognized at ₹ 290,055.

5.2. Subsequent measurement

After the initial recognition, the lessee shall measure the the liability to make lease payments at its amortized cost using the effective interest method and the right-of-use asset at amortized cost (unless the lessee elects to revalue the right-of-use asset as discussed in point 5.2.2 below). The lessee shall amortize the asset on a systematic basis from the date of commencement of the lease to the end of the lease term or over the useful life of the underlying asset if shorter. Thus, in the statement of comprehensive income, a lessee shall recognize:

- an amortization of the right-of-use asset
- an interest expense on the liability to make lease payments

Exhibit 1 summarily illustrates the items recognized in lessee's financial statements.

5.2.1. Reassessment of the liability to make lease payments

The ED requires a lessee to reassess, at every reporting date, the carrying amount of the liability to make lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period.

- **Change in the lease term** A change in the liability to make lease payments resulting from the reassessment of the length of the lease term shall be adjusted against the right-of-use asset.
- **Change in the expected amount of any contingent rentals** A change in the liability to make lease payments resulting from the reassessment of expected amount of any

Exhibit 1

Summary illustration of the items recognized in lessee's financial statements (*amounts are illustrative only*)

Balance sheet		Income statement	
a. Right-of-use asset	₹ 290,055	Amortization expense	₹ 97,018 Dr.
b. Liability to make lease payments	₹ 285,055	Interest expense	₹ 20,664 Dr.

Amortization expense arises due to systematic write down of right-of-use asset for example based on the term of the lease. The interest expense shall arise due accretion of liability for time value of money following the amortized cost accounting using the effective interest method.

contingent rentals shall be adjusted:

a. in profit or loss, to the extent that those changes relate to current or prior periods
b. as an adjustment to the right-of-use asset to the extent that those changes relate to future periods

For example, when lease payments depend on the amount of the lessee's sales, changes relating to sales in the current or prior periods are recognized in profit or loss, whereas changes relating to expectations of future sales are recognized as an adjustment to the right-of-use asset.

5.2.2. Revaluation of the right-of-use asset

As mentioned earlier, after intial recognition, a lessee shall measure its right-of-use asset at amortized cost. However, alternatively, if the lessee follows revaluaion model for a class of property, plant and equipment, in accordance with IAS 16 *Property, Plant and Equipment,* it may measure a right-of-use asset relating to that class of property, plant and equipment at its fair value.

> The ED proposes that a lessee will recognize a 'liability to make lease payments' equal to the present value of the total lease payments and a corresponding 'right-of-use asset' at the same amount plus initial direct costs

If a lessee measures a right-of-use asset at a revalued amount, it shall revalue all right-of-use assets relating to the class of property, plant and equipment to which the underlying asset belongs. Gains and losses on revaluation in the statement of comprehensive income in accordance with IAS 38 *Intangible Assets.*

5.2.3. Impairment of the right-of-use asset

The ED requires that a lessee shall apply IAS 36 *Impairment of Assets* at each reporting date to determine whether the right-of-use asset is impaired and shall recognize any impairment loss in accordance with IAS 36.

Indian context

The requirement of the ED for accounting of leases by lessees will be a significant change from the existing practices under the Indian GAAP.

To apply the new requirements, new systems and processes will have to be put in place, like for determining present values, follow amotized cost accounting and reassessment of the liability. Managements may be required to make significant estimates with respect to contingent rentals and expected lease term. Requirement to reassess the liability to make the lease payments based on new facts and circumstances could be difficult to apply for Indian companies with large number of leasing arrangements. Also, the assets and liabilities recognized following the guidance under ED may affect the impairment computations.

The proposals in ED may also impact key business metrics. The recognition of future lease payments as 'right-of-use' asset by lessees, may result in higher capital base and may impact key business performance ratios like lower asset turnover and lower return on assets ratio. Further, the requirement to reassess the liability may result in volatility In the income statement. Recognition of rental expense as amortization expense and interest expense may result in a higher reported EBITDA (earnings before interest, taxes, depreciation and amortization) for lessees. The recognition of additional assets and liabilities may also result in related deferred tax implications and will accordingly impact PAT (profit after tax).

Not only the managements of Indian companies adopting the IFRS converged accounting standards, but also the investors, lenders, bankers and analysts may find it useful to assess the requirements of the ED and its impact on the financial statements and impact on business meterics. Companies entering into loan agreements or in the process of renegotiation, may consider structuring their debt covenants to ensure that the application of the ED does not adversely affect them or give unintended results.

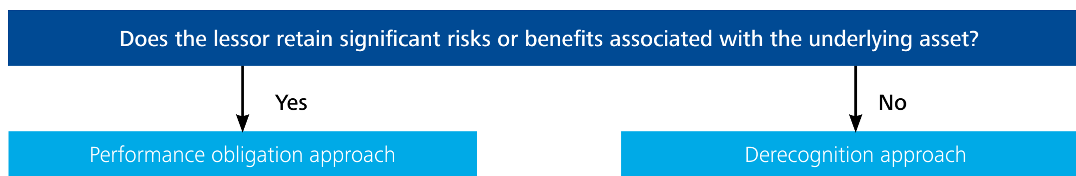
6. Accounting by lessors

Accounting for leases by lessors is also based on the right-of-use approach. This is based on the premise that in a lease arrangement, a lessor incurs a liability to grant the right to use, or control the use of, a specified asset to the lessee in return for a right to receive a series of payments.

The ED proposes two models for accounting by lessors based on the whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either:

- during the expected term of the lease; or
- after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset.

The ED proposes two models for accounting by lessors based on the whether the lessor retains exposure to significant risks or benefits associated with the underlying asset



ED requires that if a lessor retains exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the 'performance obligation' approach to the lease. If a lessor does not retain exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the 'derecognition approach' to the lease. The credit risk of the lessee would not be considered in the analysis of whether the lessor is exposed to significant risks and benefits associated with the underlying asset. A lessor shall not change the lessor accounting approach after the date of inception of the lease.

6.1. Perfromance obligation approach

Under this approach, a lessor shall recognize in the statement of financial position a right to receive lease payments and a lease liability representing lessor's obligation to permit the lessee to use the underlying asset over the lease term. The lessor shall not derecognize the underlying asset.

6.1.1. Initial recognition and measurement

Right to receive lease payments

The ED requires that at the date of commencement of a lease, a lessor shall recognize in the statement of financial position a 'right to receive lease payments'. The right to receive lease payments shall be measured equal to the present value of the total lease payments and any initial direct costs incurred by the lessor.

Indian context

Under the ED, the asset representing right to receive lease payments shall be recognized in addition to the underlying asset. Presently under the Indian GAAP, there is no requirement for recognizing assets by lessors arising out of lease transactions in case of operating leases. The proposed accounting in the ED may result in a higher asset base.

The ED provides guidance to determine right to receive lease payments for a lessor.

Lease liability

The ED further requires that under the performance obligation approach, the lessor should recognize a 'lease laibility' equal to the amount of the right to receive lease payments.

6.1.2. Subsequent measurement

Right to receive lease payments

Subsequently, the right to receive lease payments shall be measured at amortized cost using the effective interest method and interest income shall be recognized in profit or loss.

Lease liability

Subsequently, the lessor shall measure the remaining lease liability determined on the basis of the pattern of use of the underlying asset by the lessee. If the lessor cannot reliably determine the same, it shall use straight-

Exhibit 2

Summary illustratation of the items recognized in lessor's financial statements under performance obligation approach

Balance sheet		Income statement	
a. Underlying asset	₹ XXX	Depreciation expense	₹ XXX Dr.
b. Right to receive lease payments	₹ XXX	Interest income	₹ XXX Cr.
c. Lease liability	₹ XXX	Lease income	₹ XXX Cr.

Interest income will arise due to unwinding of 'right to receive lease payment' asstes following the amortized cost accounting using the effective interest method. Lease income will be recognized due to changes in the lease liability as the lessor fulfills its obligation under lease.

line method. The reduction in the amount of lease liability shall be recognized as lease income in the profit or loss.

Exhibit 2 summarily illustrates the items recognized in lessor's financial statements under performance obligation approach.

6.1.3. Reassessment of the right to receive to lease payments

The right to receive lease payments shall be reassessed at every reporting date if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period.

- **Change in the lease term** A change in the right to receive lease payments resulting from the reassessment of the length of the lease term shall be adjusted against the lease liability.
- **Change in the expected amount of any contingent rentals** A change in the right to receive lease payments resulting from the reassessment of expected amount of any contingent rentals shall be adjusted:
  a. in profit or loss, to the extent that the lessor has satisfied the related lease liability
  b. as an adjustment to the lease liability to the extent that the lessor has not satisfied the related lease liability

6.1.4. Impairment of the right to receive lease payment

A lessor shall apply IAS 39 *Financial Instruments: Recognition and Measurement* at each reporting date to determine whether the right to receive lease payments is impaired and shall recognize any impairment loss in profit or loss.

It is interesting to note that, in the books of lessors, there will be two assets under the performance obligation approach. One being the underlying asset already recognized and the other, in contrast with the Indian GAAP, being the right to receive lease payments

Indian context

The performance obligation approach for lessors corresponds to the existing accounting for operating leases by lessors. The requirement of the ED for accounting of leases by lessors following the performance obligation approach will be a significant change from the existing practices under the Indian GAAP.

To apply the new requirements, Indian companies will be required to perform systems and process changes. Requirement to reassess the right to receive lease payments based on new facts and circumstances, assessment of impairment under IAS 39, etc. will require significant additional efforts. Managements may be required to make significant estimates with respect to contingent rentals and expected lease term. The new requirements of the ED may also impact key business metrics for lessors.

It is interesting to note that, in the books of lessors, there will be two assets under the performance obligation appraoch compared with the existing accounting for operating leases under the Indian GAAP, one being the underlying asset already recognized and the other being the right to receive lease payments. Indian companies involved in leasing businesses may see a significant change in their balance sheets. The composition of income will also change from the existing practices under the Indian GAAP as the incomes dervied by lessors will be bifurcated and recognized as interest income and lease income. The timing of recognition of income will also change as the interest income will be higher in earlier periods.

6.2. Derecognition approach

At the date of commencement, under the derecognition approach, the ED requires a lessor to:

- recognize a right to receive lease payments in the statement of financial position.
- derecognize from the statement of financial position the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease
- reclassify as a residual asset the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains

6.2.1. Initial recognition and measurement

Right to receive lease payments

Under the derecognition approach, the lessor measures the asset for right to receive lease payments in the same way as under the performance obligation approach. The ED requires that at the date of commencement of a lease, a lessor shall recognize in the statement of financial position a 'right to receive lease payments'. The right to receive lease payments shall be measured equal to the present value of the total lease payments and any initial direct costs incurred by the lessor. The derecognition approach approach for lessors corresponds to the existing accounting for finance leases by lessors and is conceptually similar to existing accounting for finance leases.

Residual asset (and derecognition of underlying asset)

Residual asset represents the rights to the underlying asset retained by the lessor under the derecognition approach for lessor accounting. The residual asset will be measured at an allocated amount of the carrying amount of the underlying asset, determined as of the date of inception of the lease. The portion of the underlying asset derecognized would be calculated as of the date of inception of the lease as follows:

$$\text{Carrying amount of the underlying asset} \times \frac{\text{Fair value of the right to receive lease payments}}{\text{Fair value of the underlying asset}}$$

The remaining portion of the underlying asset that is not derecognized would represent the residual asset. All amounts are initially measured as of the date of inception of the lease.

Derecognition of underlying asset

The lessor shall recognize lease income representing the present value of the lease payments and lease expense representing the cost of the portion of the underlying asset that is derecognized at the date of commencement of the lease. A lessor shall classify lease income as revenue if it arises in the course of a lessor's ordinary activities (refer Exhibit 3 for illustration).

6.2.2. Subsequent measurement

Right to receive lease payments

Subsequently, the right to receive lease payments shall be measured at amortized cost using the effective interest method. Interest income shall be recognized in the profit or loss.

Residual asset

The residual asset shall be adjusted for reassessment of right to receive lease payment as discussed in point 6.2.3 below.

Exhibit 3 summarily illustrates the items recognized in lessor's books under derecognition approach.

Exhibit 3

Summary illustratation the items recognized in lessor's financial statements under derecognition approach

Balance sheet		Income statement	
a. Right to receive lease payments	₹ XXX	Revenue* (representing the present value of lease payments)	₹ XXX Cr.
b. Residual asset	₹ XXX	Cost of sales* (carrying amount of the underlying asset attributable to the portion derecognized)	₹ XXX Dr.
		Interest income	₹ XXX Cr.

* These amounts shall be reported gross or net based on the business model of the lessor.

6.2.3. Reassessment of the right to receive to lease payments

The right to receive lease payments shall be reassessed at every reporting date if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period.

- **Change in the lease term** A change in the right to receive lease payments resulting from the reassessment of the length of the lease term shall be allocated to the rights derecognized and the residual asset and the carrying amount of the residual asset shall be adjusted accordingly. The amount attributable to the derecognized asset shall be recognized in the profit or loss.

- **Change in the expected amount of any contingent rentals** A change in the right to receive lease payments resulting from the reassessment of expected amount of any contingent rentals shall be adjusted in profit or loss.

6.2.4. Impairment of the right to receive lease payment and the residual asset

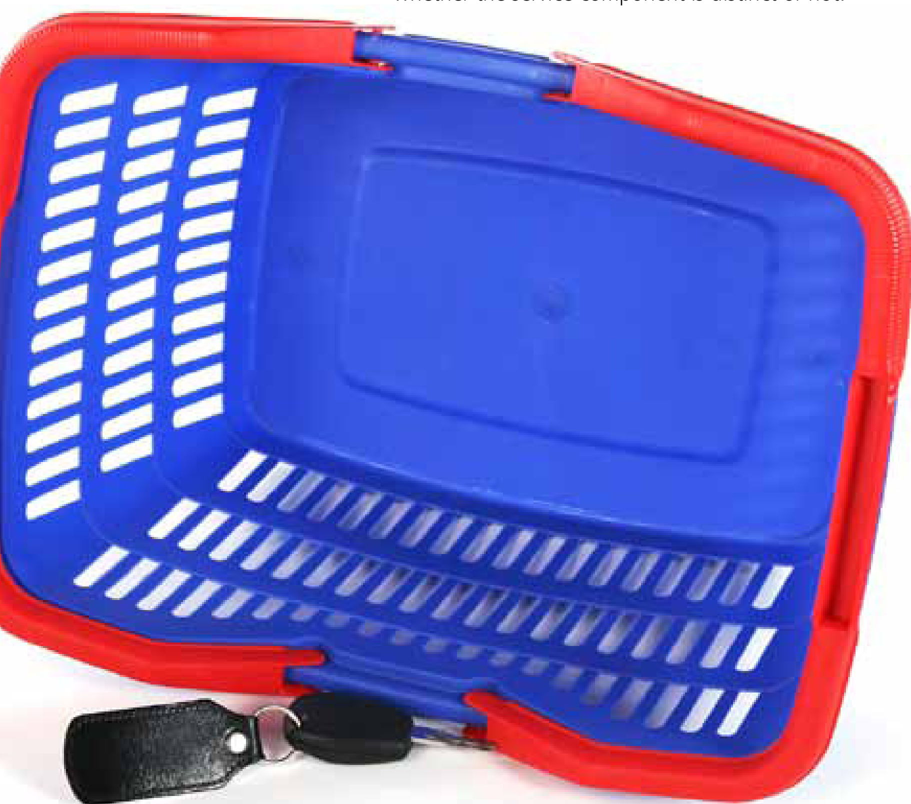
Under the derecognition approach, the right to receive lease payment and the residual asset shall be tested for imapirment in accordance with IAS 39 and IAS 36, respectively. A lessor shall recognize any impairment loss in profit or loss.

7. Other key aspects of the ED

7.1. Contracts that contain service and lease components

Lessee/lessor shall apply [exposure draft] *Revenue from Contracts with Customer*s to a service component of a contract that contains service components and lease components if the service component is distinct and the lessee/lessor is able to do so. Otherwise, the entire contract that contains service and lease components shall be accounted for as a lease under the ED.

Derecognition approach - exception A lessor that applies the derecognition approach shall shall apply [exposure draft] *Revenue from Contracts with Customers* to a service component of such a contract, irrespective of whether the service component is distinct or not.



Indian context

For Indian companies, the requirement of the ED with respect to contracts that contain service and lease components will be a significant change form the existing practices under the Indian GAAP. It will not only involve additonal efforts to identify and separate distinct service components in such contracts but will also involve significant estimates in allocating the amounts to service and lease components.

This requirement of the ED coupled with the guidance adapted from IFRIC 4 may impact large number of Indian companies engaged in service contracts that contain lease elements.

7.2. Short-term leases

Under the ED, short-term lease is defined as a *lease that, at the date of commencement of the lease, has a maximum possible lease term including options to renew or extend, of twelve months or less.* The ED provides relief in respect of accounting for short-term leases.

A lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (a) the liability to make lease payments at the undiscounted amount of the lease payments and (b) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees shall recognize lease payments in profit or loss over the lease term.

A lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors shall continue to recognize the underlying asset in accordance with other IFRSs and shall recognize lease payments in profit or loss over the lease term.

Indian context

A simplified accounting for short-term leases may encourage companies to structure leases as short-term. However, under the proposed model, the lease term shall be determined by taking into account the effect of any options to extend or terminate the lease. It may not be practical to achieve accounting prescribed for short-term leases only by restructuring the arrangements.

7.3. Subleases

Sublease is defined as a transaction in which an underlying asset is re-leased by the original lessee (or 'intermediate lessor') to a third party, and the lease agreement (or 'head lease') between the original lessor and lessee remains in effect. The same entity is both a lessee that leases an asset from a head lessor, and an intermediate lessor that subleases the same underlying asset to a sublessee. The ED requires an intermediate lessor would account for its assets and liabilities arising from the head lease in accordance with the lessee model and would account for its assets and liabilities arising from the sublease in accordance with the lessor model.

7.4. Sale and leaseback transations

The ED contains detailed guidance in case of sale and leaseback transactions. The ED provides that a transaction that meets the criteria of sale and leaseback shall be accounted for as sale/purchase and the lease component shall be accounted in accordance with the ED. In case, the transaction does not meet the criteria for sale and leaseback, the same shall be accounted for as financing arrangement.

Indian context

An entity considers the effect of the transfer contract and the lease contract together to assess whether the transferred asset has been purchased or sold. The ED in its application guidance contains various examples that would preclude a transaction from being accounted for as sale and leaseback. Some of the situations in such examples may have been accounted for as sale and lease back under the Indian GAAP in the absence of a similar specific guidance and accordingly will require change in accounting practices.

Further, under the Indian GAAP, the accounting treatment of a sale and leaseback transaction depends upon the type/ classification of lease involved. However, the ED proposes that such transactions should be accounted for as sale/purchase and the leaseback should be accounted for in accordance with the ED. This could result in significant change in the accounting from the existing practice.

7.5. IFRIC 4 Determining whether an arrangement contains a lease

Under IFRSs, IFRIC 4 contains principles to determine whether arrangements, that does not take the legal form of a lease, are or contain leases. The determination under IFRIC 4 is based on the substance of the arrangment and

- whether the arrangement is dependant on the use of a specified asset, and
- whether there is a convey of right to use of the specified asset.

The guidance under IFIRC 4 has been incorporated in the draft standard itself as application guidance. Although, there is no change in the principles in ED from IFRIC 4, this is a significant change from the Indian GAAP which does not contain a corresponding guidance.

7.6. Transtional provisions

The ED provides for a simplified retrospective apporach for the purpose of transition to the new standard.

7.6.1. Lessees

The ED provides that a lessee can recognize the liability to make lease payments and the right-of-use asset at present value on the date of transition. Leases classified as finance leases under IAS 17 that do not have options, contingent rentals, term option penalties or residual

value guarantees shall be measured on transition at the carrying amounts under IAS 17.

7.6.2. Lessors

For the performance obligation approach, the ED provides that a lessor can recognize its a right to receive lease payments and the lease liability at present value on the date of transition. On transition, the lessor shall reinstate previously derecognized underlying assets at depreciated cost, determined as if the asset had never been derecognized, subject to any adjustments required to reflect impairment and revaluation.

For the derecognition appproach, the ED provides that a lessor can recognize the right to receive lease payments at present value on the date of transition and recognize the residual asset at fair value on the date of transition.

Indian context

Although the transitional provisions provide significant relief from full retrospective application, the Indian companies first-time adopting the proposed standard will still be required to collect large amount of additional data, especially for lessees, as it will require setting a new starting point for present value accounting. Further, the managements of the Indian companies may want to sensitize their stakeholders in order to enable them understand the changes proposed by ED. In our observation, this exercise will require an early start by the Indian companies.

7.7. Presentation and disclosures

The ED contains detailed presentation and disclosure requirements for lessees and lessors under the performance obligation approach as well as the derecognition approach.

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