INDAS – 116
LEASES

(TOTAL NO. OF QUESTIONS – 13)

INDEX

RTPs QUESTIONS

Q1 (Nov. 18)

A Ltd. prepares its financial statements for the period ending on 31st March each year. The financial statement for the year ended 2017-2018 is under preparation. The following events are relevant to these financial statements:

On 1st April, 2016, A Ltd. purchased an asset for Rs2,00,00,000. The estimated useful life of the asset was 10 years, with an estimated residual value of zero. A Ltd. immediately leased the asset to B Ltd. The lease term was 10 years and the annual rental, payable in advance by B Ltd., was Rs27,87,000. A Ltd. incurred direct costs of Rs2,00,000 in arranging the lease. The lease contained no early termination clauses and responsibility for repairs and maintenance of the asset rest with B Ltd. for the duration of the lease. The annual rate of interest implicit in the lease is 8%. At an annual discount rate of 8% the present value of Rs 1 receivable at the start of years 1–10 is Rs 7·247.

Examine and show how the above event would be reported in the financial statements of A Ltd. for the year ended 31st March, 2018 as per Ind AS.

SOLUTION

(All Fig. in Rs. '000)

The lease of the asset by A Ltd. to B Ltd. would be regarded as a finance lease because the risks and rewards of ownership have been transferred to B Ltd. Evidence of this includes the lease is for the whole of the life of the asset and B Ltd. being responsible for repairs and maintenance.

As per para 36 of Ind AS 17, since the lease is a finance lease and A Ltd. is the lessor, A Ltd. will recognise a financial asset i.e. as a receivable at an amount equal to the 'net investment in finance leases. The amount recognised will be the present value of the minimum lease payments which will be 20,197.39 i.e. 2,787 x 7.247.

The impact of the lease on the financial statements for the year ended 31st March, 2018 can best be seen by preparing a profile of the net investment in the lease for the first three years of the lease and shown below:

Year Ending	Opening Balance	Rental	Finance income	Rental	Closing Balance
2017	20,197.39	(2,787)	1392.831		18803.22
2018	18803.22	(2,787)	1281.298		17297.518
2019	17297.518	(2,787)	1160.84		15671.359

During the year ended 31st March, 2018, A Ltd. will recognise income from finance leases of 1,281.298

The net investment on 31st March, 2018 will be 17,297.518.

Of the closing net investment of 17,761.27, current asset will be shown for 2,787 and 14,510.518 as a non-current asset.

Note: In Suggested Answer, rental is being assumed as paid at the end but in question it is clearly given that it is being paid in advance

Q2 (Nov. 19)

Jeevan India Limited is in the business of development of smart city. For development of smart city, Jeevan India Limited allots its land to customer on 99 years of lease. The customer is required to pay lease premium at the time of execution of lease deed and lease rent on annual basis over a period of 99 years.

The lease premium amount is the market value of land and lease rent is nominal amount say Rs. 1 per square metre per year. The lease premium is non-refundable. As per the lease terms, on completion of 99 years, the lease is renewable at mutual consent of lessor and lessee.

How would income in respect of lease premium collected by Jeevan India Limited (which is the market value of land and is not refundable) at the time of execution of lease deed be recognised as per Ind AS, if for subsequent years, only nominal lease rent is collected.

SOLUTION

Paragraph 5 of Ind AS 115 scopes out revenue arising from lease agreements. Principles enunciated under Ind AS 116, Leases would be applicable for revenue arising from leasing agreements.

Recognition of income in respect of lease would depend on its classification as per Ind AS 116, Leases.

(a) **If the lease of land is an operating lease**, then it will be accounted for as given below:

(i) Lessors shall present assets subject to operating leases in their balance sheet according to the nature of the asset.

(ii) Lease income from operating leases shall be recognised in income on a straight- line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished, even if the payments to the lessors are not on that basis;

(b) The long lease term may be an indication that the lease is classified as a finance lease. **If it is a**

finance lease then lessor Jeevan India Ltd. shall recognise assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease. The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.

Q3 (Nov. 20)

Entity X (p) entered into a lease agreement ('lease agreement') with Entity Y (lessor) to lease an entire floor of a shopping mall for a period of 9 years. The monthly lease rent is Rs. 70,000. To carry out its operations smoothly, Entity X simultaneously entered into another agreement ('facilities agreement') with Entity Y for using certain other facilities owned by Entity Y such as passenger lifts, DG sets, power supply infrastructure, parking space etc., which are specifically mentioned in the agreement, for monthly service charges amounting to Rs. 1,00,000. As per the agreement, the ownership of the facilities shall remain with Entity Y. Lessee's incremental borrowing rate is 10%.

The facilities agreement clearly specifies that it shall be co-existent and coterminous with 'lease agreement'. The facility agreement shall stand terminated automatically on termination or expiry of 'lease agreement'.

Entity X has assessed that the stand-alone price of 'lease agreement' is Rs. 1,20,000 per month and stand-alone price of the 'facilities agreement' is Rs. 80,000 per month. Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component(s) from lease component(s) and accordingly it separates non-lease components from lease components.

How will Entity X account for lease liability as at the commencement date?

SOLUTION

Entity X identifies that the contract contains lease of premises and non-lease component of facilities availed. As Entity X has not elected to apply the practical expedient as provided in paragraph 15, it will separate the lease and non-lease components and allocate the total consideration of Rs. 1,70,000 to the lease and non-lease components in the ratio of their relative stand-alone selling prices as follows:

Particulars	Stand-alone Prices	% of total Stand-alone Price	Allocation of consideration
	Rs.		Rs.
Building rent	1,20,000	60%	1,02,000
Service charge	80,000	40%	68,000
Total	**2,00,000**	**100%**	**1,70,000**

As Entity X's incremental borrowing rate is 10%, it discounts lease payments using this rate & the lease liability at the commencement date is calculated as follows:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A X B = C)
Year 1	1,02,000	.909	92,718
Year 2	1,02,000	.826	84,252

Year 3	1,02,000	.751	76,602
Year 4	1,02,000	.683	69,666
Year 5	1,02,000	.621	63,342
Year 6	1,02,000	.564	57,528
Year 7	1,02,000	.513	52,326
Year 8	1,02,000	.467	47,634
Year 9	1,02,000	.424	43,248
Lease Liability at commencement date			**5,87,316**

Further, Rs. 68,000 allocated to the non-lease component of facility used will be recognised in profit or loss as and when incurred.

Q4 (May 21)

Entity X is an Indian entity whose functional currency is Indian Rupee. It has taken a plant on lease from Entity Y for 5 years to use in its manufacturing process for which it has to pay annual rentals in arrears of USD 10,000 every year. On the commencement date, exchange rate was USD = Rs.68. The average rate for Year 1 was Rs. 69 and at the end of year 1, the exchange rate was Rs.70. The incremental borrowing rate of Entity X on commencement of the lease for a USD borrowing was 5% p.a.

How will entity X measure the right of use (ROU) asset and lease liability initially and at the end of Year 1?

SOLUTION

On initial measurement, Entity X will measure the lease liability and ROU asset as under:

Year	Lease Payments (USD)	Present Value factor @5%	Present Value of Lease Payment	Conversion rate (spot rate)	INR value
1	10,000	0.952	9,520	68	6,47,360
2	10,000	0.907	9,070	68	6,16,760
3	10,000	0.864	8,640	68	5,87,520
4	10,000	0.823	8,230	68	5,59,640
5	10,000	0.784	7,840	68	5,33,120
Total			**43,300**		**29,44,400**

As per Ind AS 21, The Effects of Changes in Foreign Exchange Rates, monetary assets and liabilities are restated at each reporting date at the closing rate and the difference due to foreign exchange movement is recognised in profit and loss whereas non-monetary assets and liabilities carried measured in terms of historical cost in foreign currency are not restated.

Accordingly, the ROU asset in the given case being a non-monetary asset measured in terms of historical cost in foreign currency will not be restated but the lease liability being a monetary liability will be restated at each reporting date with the resultant difference being taken to profit and loss.

At the end of Year 1, the lease liability will be measured in terms of USD as under: Lease Liability:

Year	Initial Value (USD) (a)	Lease Payment (b)	Interest @5% (c)= (a x 5%)	Closing Value (USD) (d = a+ c-b)
1	43,300	10,000	2,165	35,465

Interest at the rate of 5% will be accounted for in profit and loss at average rate of Rs.69 (i.e., USD 2,165 x 69) =Rs. 1,49,385.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Interest Expense	Dr.	1,49,385	
To Lease liability			1,49,385

Lease payment would be accounted for at the reporting date exchange rate, i.e. Rs.70 at the end of year 1

Particulars		Dr. (Rs.)	Cr. (Rs.)
Lease liability	Dr.	7,00,000	
To Cash			7,00,000

As per the guidance above under Ind AS 21, the lease liability will be restated using the reporting date exchange rate i.e., Rs.70 at the end of Year 1. Accordingly, the lease liability will be measured at Rs.24,82,550 (35,465 x Rs. 70) with the corresponding impact due to exchange rate movement of Rs. 88,765 (24,82,550 – (29,44,400 + 1,49,385 – 700,000) taken to profit and loss.

At the end of year 1, the ROU asset will be measured as under:

Year	Operating Balance (Rs.)	Depreciation (Rs.)	Closing Balance (Rs.)
1	29,44,400	5,88,880	23,55,520

Q5 (Nov. 21)

The Company has entered into a lease agreement for its retail store as on 1st April, 20X1 for a period of 10 years. A lease rental of Rs. 56,000 per annum is payable in arrears. The Company recognized a lease liability of Rs. 3,51,613 at inception using an incremental borrowing rate of 9.5% p.a. as at 1st April 20X1. As per the terms of lease agreement, the lease rental shall be adjusted every 2 years to give effect of inflation. Inflation cost index as notified by the Income tax department shall be used to derive the lease payments. Inflation cost index was 280 for financial year 20X1-20X2 and 301 for financial year 20X3-20X4. The current incremental borrowing rate is 8% p.a. Show the Journal entry at the beginning of year 3, to account for change in lease.

SOLUTION

As per para 27 (b) of Ind AS 116, variable lease payments that depend on an index or a rate, are initially measured using the index or rate as at the commencement date.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of Rs. 60,200 discounted at an original discount rate of 9.5% per annum as per para 43 of Ind AS 116.

Year	Revised lease rental	Discount factor @ 9.5%	Present value
3	[(56,000 / 280) x 301] = 60,200	0.913	54,963
4	60,200	0.834	50,207
5	60,200	0.762	45,872
6	60,200	0.696	41,899
7	60,200	0.635	38,277
8	60,200	0.580	34,916
9	60,200	0.530	31,906
10	60,200	0.484	29,137
			3,27,127

Table showing amortised cost of lease liability

Year	Opening balance	Interest @ 9.5%	Rental paid	Closing balance
1	3,51,613	33,403	56,000	3,29,016
2	3,29,016	31,257	56,000	3,04,273

Difference of Rs. 22,854 (3,27,127 – 3,04,273) will increase the lease liability with corresponding increase in ROU Asset as per para 39 of Ind AS 116.

Journal entry at the beginning of year 3 would be:

Right-of-use asset Dr. Rs. 22,854

To Lease liability Rs. 22,854

Q6 (April. 19)

On 1 April 2017, Jupiter ltd began to lease a property on a 20-year lease. Jupiter ltd paid a lease premium of Rs. 30,00,000 (One Time payment) on 1 April 2017. The terms of the lease required Jupiter ltd to make annual payments of Rs. 500,000 in arrears, the first of which was made on 31 March 2018.

On 1 April 2017 the fair values of the leasehold interests in the leased property were as follows:

– Land Rs. 30,00,000.

– Buildings Rs. 45,00,000.

There is no opportunity to extend the lease term beyond 31 March 2037. On 1 April 2017, the estimated useful economic life of the buildings was 20 years.

The annual rate of interest implicit in finance leases can be taken to be 9·2%. The present value of 20 payments of Rs1 in arrears at a discount rate of 9·2% is Rs. 9.

Required:

Explain the accounting treatment for the above property lease in the books of Lessor.

***Solve this question from Lessor's point of View.**

SOLUTION

Statement of Profit and Loss

	Rs. '000
Operating lease rental	(260)
Amortisation of asset leased on finance lease	(225)
Finance cost relating to finance leases	(248·4)

Balance Sheet

	Rs. '000
Property, plant and equipment	4,275
Prepaid operating lease rentals:	
In non-current assets	1,080
In current assets	60
Lease liability:	
In non-current liabilities	(2,592·1)
In current liabilities	(56·3)

Explanation and supporting calculations:

Separate decisions are made for the land and buildings elements of the lease.

1) The land lease is an operating lease because land has an indefinite useful economic life and the lease term is 20 years.

   The lease premium and annual rentals are apportioned 40% (3/7·5) to the land element.

   Therefore, the premium for the land element is Rs. 12,00,000 (Rs. 30,00,000 x 40%) and the annual rentals for the land element Rs. 200,000 (Rs. 500,000 x 40%). This makes the total lease payments Rs. 52,00,000 (Rs. 12,00,000 + 20 x Rs. 200,000).

   The rental expense for the current period is Rs. 2,60,000 (Rs. 52,00,000 x 1/20).

The amount paid in the current period regarding the land element is Rs. 14,00,000 (Rs. 12,00,000 + Rs. 200,000). Therefore, there is a prepayment of Rs. 1,140,000 (Rs. 14,00,000 – Rs. 2,60,000) at the year end.

In the next 19 periods, the rental expense will be Rs. 260,000 and the rental payment will be Rs. 200,000. Therefore Rs. 60,000 of the rental pre-payment will reverse in each period. This means that Rs. 60,000 of the pre-payment will be a current asset, and the balance a non-current asset.

2) The buildings element of the lease will be a finance lease because the lease term is for substantially all of the useful life of the buildings. The premium apportioned to the building element is Rs. 18,00,000 (Rs. 30,00,000 x 60%) and the annual rental apportioned to the buildings is Rs. 300,000 (Rs. 500,000 x 60%). The initial carrying value of the leased asset in PPE is Rs. 45,00,000 (Rs. 18,00,000 + Rs. 300,000 x 9). Therefore, the annual depreciation charge is Rs. 2,25,000 (Rs. 45,00,000 x 1/20) and the closing PPE = Rs. 42,75,000 (Rs. 45,00,000 – Rs. 2,25,000). The finance cost in respect of the finance lease and the closing non-current liability is shown in the working below. The closing current liability is Rs. 56,300 (Rs. 26,48,400 – Rs. 25,92,100).

Lease liability profile – working

Year ended 31st March	Bal b/f Rs.'000	Finance Cost @ 9.2% Rs. '000	Lease rental payment Rs. '000	Bal c/f Rs. '000
2018	*2,700	248·4	(300)	2,648·4
2019	2,648·4	243·7	(300)	2,592·1

* Balance brought forward is equal to net of lease premium of Rs. 18,00,000 i.e. Rs. 45,00,000 – Rs. 18,00,000 = Rs. 27,00,000.

Q7 (May 20 – 16 Marks)

Company EFG enters into a property lease with Entity H. The initial term of the lease is 10 years with a 5- year renewal option. The economic life of the property is 40 years and the fair value of the leased property is Rs.50 Lacs. Company EFG has an option to purchase the property at the end of the lease term for Rs.30 lacs. Lease is paid at the beginning of the year. The first annual payment is Rs.5 lacs with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of Rs. 2 lacs (payable at the beginning of year 2), which is to be used for normal tenant improvement.

Company EFG is reasonably certain to exercise that purchase option. How would EFG measure the right-of-use asset and lease liability over the lease term?

SOLUTION

As per Ind AS 116, Company EFG would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (W.N. 1)	Rs. 37,39,648
PV of purchase option at end of lease term (W.N. 2)	Rs. 12,60,000
Total lease liability	Rs. 49,99,648 or Rs. 50,00,000
	(approx.)

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Company EFG, lease payments made at or before the lease commencement date, or lease incentives received prior to the lease commencement date.

Entity EFG would pass the following journal entry on the lease commencement date.

Right-of-use Asset	Dr.	Rs. 50,00,000	
To Lease Liability			Rs. 50,00,000
To record ROU asset and lease liability at the commencement date.			

Since the purchase option is reasonably certain to be exercised, EFG would amortize the right-of- use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be Rs. 1,25,000 (Rs. 50,00,000 / 40 years)

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year
	a	b= a-c	c = (d of pvs. year)	d = [(e of pvs. year- a) x 9.04%]	e = (e of pvs. year + d – a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213**	30,00,000
Year 10	30,00,000	27,50,787	2,49,213*	-	-
Total	**85,31,940**	**50,00,000**	**35,31,940**	**35,31,940**	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

**Difference of Rs. 542 (Rs. 2,48,671 and Rs. 2,49,213) is due to rounding of interest expense calculated @ 9.04%.

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

Working Notes:

1. **Calculating PV of lease payments, less lease incentive:**

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A x B=C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555
Year 6	5,79,637	0.65	3,76,764
Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	3,00,098
Total			**37,39,648**

2. **Calculating PV of purchase option at end of lease term:**

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A x B=C)
Year 10	30,00,000	0.42	12,60,000
Total			**12,60,000**

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

Q8 (MTP May 21 – 10 Marks)

Buildings Limited entered into a 10-year lease for 6,000 square meter of office space. The annual lease payments are Rs. 60,000 payables at the end of each year. The interest rate implicit in the lease cannot be readily determined. Buildings Limited's incremental borrowing rate at the commencement date is 8% p.a. At the beginning of 6th year, Buildings Limited and lessor agree to amend the original lease to reduce the space to only 3,000 square meters of the original space starting from the end of the first quarter of year 6. The annual fixed lease payments (from year 6 to year 10) are Rs. 35,000. Buildings Limited's incremental borrowing rate at the beginning of year 6 is 6% p.a.

The CFO of the Company has requested your suggestion on how to account for the modification in the lease of office space? Prepare the detailed working for the modification.

SOLUTION

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 8%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 8%	d = a-b + c	e	f	g
1	4,02,600*	60,000	32,208	3,74,808	4,02,600	40,260	3,62,340
2	3,74,808	60,000	29,985	3,44,793	3,62,340	40,260	3,22,080
3	3,44,793	60,000	27,583	3,12,376	3,22,080	40,260	2,81,820
4	3,12,376	60,000	24,990	2,77,366	2,81,820	40,260	2,41,560
5	2,77,366	60,000	22,189	2,39,555	2,41,560	40,260	2,01,300
6	**2,39,555**				**2,01,300**		

* Initial value of ROU asset and lease liability = Annual lease payment x annuity factor @ 8%
= 60,000 x 6.71 = Rs. 4,02,600

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of Rs. 35,000 and

(c) Lessee's incremental borrowing rate of 6% p.a.

Present value of modified lease = Annual lease payment x annuity factor @ 6% = 35,000 x 4.212 = 1,47,420

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 3,000 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (Rs. 2,01,300) is Rs. 1,00,650

50% of the pre-modification lease liability (Rs. 2,39,555) is Rs. 1,19,777.50.

Consequently, Lessee reduces the carrying amount of the ROU Asset by Rs. 1,00,650 and the carrying amount of the lease liability by Rs. 1,19,777.50. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (Rs. 1,19,777.50 – Rs. 1,00,650 = Rs. 19,127.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of Rs. 1,19,777.50 and the modified lease liability of Rs. 1,47,420 (which equals Rs. 27,642.50) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Q9 (MTP Nov. 21 – 16 Marks)

A retailer (lessee) entered into 3-year lease of retail space beginning at 1st April 20X1 with three annual lease payments of Rs. 2,00,000 due on 31st March 20X2, 20X3 and 20X4, respectively. The lease is classified as an operating lease under the erstwhile, accounting standard. The retailer initially applies Ind AS 116 for the first time in the annual period beginning at 1st April 20X3. The incremental borrowing rate at the date of the initial application (i.e., 1st April 20X3) is 10% p.a. and at the commencement of the lease (i.e., 1st April 20X1) was 12% p.a. The ROU asset is subject to straight-line depreciation over the lease term. Assume that no practical

expedients are elected, the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.

What would be the impact for the lessee as per Ind AS 116 using the following transition approaches:

(i) Full Retrospective Approach

(ii) Modified Retrospective Approach (when ROU asset is not equal to lease liability)

Show the impact of adjustments through journal entries, consequent to transition for the year 20X2-20X3 and 20X3-20X4.

SOLUTION

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1st April, 20X1 in this case) using the incremental borrowing rate at lease commencement date (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. The Lease Liability and ROU Asset are as follows:

Year	Payments (Cash flows)	Present Value Factor @ 12%	Discounted Cash flows / Present Value
31 Mar 20X2	2,00,000	0.8929	1,78,580
31 Mar 20X3	2,00,000	0.7972	1,59,440
31 Mar 20X4	2,00,000	0.7118	1,42,360
	6,00,000		**4,80,380**

Lease Liability Schedule:

Year	Opening	Interest Expense @ 12%	Payments	Closing
31 Mar 20X2	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 20X3	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 20X4	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 20X2	4,80,380	(1,60,126)	3,20,254
31 Mar 20X3	3,20,254	(1,60,127)	1,60,127
31 Mar 20X4	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1 Apr 20X1	4,80,380	4,80,380	-	-	-
31 Mar 20X2	3,20,254	3,38,026	-	-	-
1 Apr 20X2	3,20,254	3,38,026			(17,772)
31 Mar 20X3	1,60,127	1,78,589	40,563	1,60,127	-

1 Apr 20X3	1,60,127	1,78,589	-	-	-
31 Mar 20X4	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April, 20X3. Hence, 20X3-20X4 is the first year of adoption and using Full retrospective method the comparative for 20 X2-20X3 needs to be restated and 1st April, 20X2 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1st April, 20X2 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April, 20X2 (assuming that only the 20X2-20X3 financial information is included as comparatives).

ROU Asset	Dr.	3,20,254	
Retained Earnings	Dr.	17,772	
To Lease Liability			3,38,026
To initially recognise the lease-related asset and liability as of 1 April 20X2.			

The following journal entries would be recorded during 20X2-20X3:

Interest expense	Dr.	40,563	
To Lease Liability			40,563
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

The following journal entries would be recorded during 20X3-20X4:

Interest expense	Dr.	21,411	
To Lease Liability			21,411
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Modified Retrospective Approach (When ROU asset is not equal to lease liability):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April, 20X3 to 31st March, 20X4 in this case) discounted using the incremental borrowing rate as of the date of initial application being 1st April, 20X3 (i.e. 10% p.a. in this case). The ROU asset is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 1st April 20X1 in this case) by using incremental borrowing rate as at transition date. The Lease Liability and ROU Asset are as follows:

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 20X4	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	Opening Balance	Interest Expense @ 10%	Payments	Closing Balance
31 Mar 20X4	1,81,820	18,180*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening Balance	Depreciation	Closing Balance
31 Mar 20X4	1,65,787***	(1,65,787)	-

***(Refer W.N.3)

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1 Apr 20X1	4,97,360*	4,97,360**	-	-	-
31 Mar 20X2	3,31,574	3,47,096	49,736	1,65,786	-
31 Mar 20X3	1,65,787	1,81,806	34,710	1,65,787	(16,019)
1 Apr 20X3	1,65,787	1,81,806	-	-	-
31 Mar 20X4	-	-	18,194	1,65,787	-

*(Refer W.N.1)

**(Refer W.N.2)

At adoption, the lessee would record the ROU asset and lease liability at 1 st April 20X3 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as 1st April 20X3.

ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
To initially recognise the lease-related asset and liability as of 1st April 20X3.			

The following journal entries would be recorded during 20X3-20X4:

Interest expense	Dr.	18,194	
To Lease Liability			18,194
To record interest expense and accrete the lease liability using the interest method.			

Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Working Notes

1. Calculation of Present value of lease payments as at commencement date i.e., 1st April, 20X1

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash ows / Present Value
31 Mar 20X2	2,00,000	0.9091	1,81,820
31 Mar 20X3	2,00,000	0.8264	1,65,280
31 Mar 20X4	2,00,000	0.7513	1,50,260
	6,00,000		**4,97,360**

2. Lease Liability Schedule:

Year	Opening	Interest Expense @ 10%	Payments	Closing
31 Mar 20X2	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 20X3	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 20X4	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

3. Calculation of ROU asset as at transition date i.e., 1st April, 20X3

Year	Opening	Depreciation	Closing
31 Mar 20X2	4,97,360	(1,65,786)	3,31,574
31 Mar 20X3	3,31,574	(1,65,787)	1,65,787
31 Mar 20X4	1,65,787	(1,65,787)	-

QUESTIONS FROM PAST EXAM PAPERS

Q10. (Nov. 20 – 8 Marks)

Venus Ltd (Seller-lessee) sells a building to Mars Ltd (Buyer-lessor) for cash of ₹ 28,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 13,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with an annual-payments of 2,00,000 payable at the end of each year.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in accordance with Ind AS 115 "Revenue from Contracts with Customers".

The fair value of the building at the date of sale is ₹ 25,00,000. Initial direct costs, if any, are to be ignored.

The interest rate implicit in the lease is 12% p.a., which is readily determinable by Seller-lessee. Present Value (PV) of annual payments (20 payments of ₹ 2,00,000 each discounted @ 12%) is ₹ 14,94,000.

Buyer-lessor classifies the lease of the building as an operating lease.

How should the said transaction be accounted by Venus Ltd?

SOLUTION

Considering facts of the case, Venus Ltd. (seller-lessee) and Mars Ltd. (buyer-lessor) account for the transaction as a sale and leaseback.

Firstly, since the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer - lessor make-adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of Rs.3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price:	28,00,000
Less: Fair Value (at the date of sale):	(25,00,000)
Additional financing provided by Buyer-lessor to Seller-lessee	3,00,000

The present value of the annual payments is Rs.14,94,000 (as given in the question).

Out of this Rs.14,94,000, Rs.3,00,000 relates to the additional financing (as calculated above) and balance Rs .11,94,000 relates to the lease.

Accounting by Venus Ltd. (seller-lessee):

At the commencement date, Seller-lessee measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, calculated as follows:

Carrying Amount	(A)	13,00,000
Fair Value (at the date of sale)	(B)	25,00,000
Discounted lease payments for the 20-year ROU asset (C)		11,94,000
ROU Asset	**[(A / B) x C]**	**6,20,880**

Seller-lessee recognizes only the amount of the gain that relates to the rights transferred to Buyer-lessor, calculated as follows:

Fair Value (at the date of sale)	(A)	25,00,000
Carrying Amount	(B)	13,00,000
Discounted lease payments for the 20-year ROU asset (C)		11,94,000
Gain on sale of building	**(D) = (A - B)**	**12,00,000**
Relating to the right to use the building retained by Seller-lessee (E)=[(D/A) x C]		5,73,120

Relating to the rights transferred to Buyer-lessor	**(D - E)**	**6,26,880**

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Bank / Cash A/c	Dr.	28,00,000	
ROU Asset A/c	Dr.	6,20,880	
To Building			13,00,000
To Financial Liability			14,94,000
To Gain on rights transferred			6,26,880

Q11. (Jan. 21 – 6 Marks)

Coups Limited availed a machine on lease from Ferrari Limited. The terms and conditions of the lease are as under:

Lease period is 3 years, machine costing Rs. 8,00,000

- Machine has expected useful life of 5 years.
- Machine reverts back to Ferrari Limited on termination of lease.
- The unguaranteed residual value is estimated at Rs. 50,000 at the end of 3rd year.
- 3 equal annual installments are made at the end of each year.
- Implicit Interest Rate (IRP)= 10%.
- Present value of Rs. 1 due at the end of 3rd year at 10% rate of interest is 0.7513.
- Present value of annuity of Rs. 1 due at the end 3rd year at 10% IRP is 2.4868.

You are required to ascertain whether it is Finance Lease or Operating Lease and also calculate Unearned Finance Income with the relevant context to relevant Ind AS.

SOLUTION

It is assumed that the fair value of the machine on lease is equivalent to the cost of the machine.

(i) A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

(ii) Computation of annual lease payment to the lessor

	Rs.
Cost of equipment / fair value	8,00,000
Unguaranteed residual value	50,000
Present value of residual value after third year @ 10% (50,000 x 0.7513)	37,565
Fair value to be recovered from lease payments (8,00,000 – 37,565)	
Present value of annuity for three years is 2.4868	7,62,435
Annual lease payment = 7,62,435 / 2.4868	
	3,06,593

The present value of lease payment i.e., Rs.7,62,435 is more than 95% of the fair market value i.e., Rs. 8,00,000. The present value of minimum lease payments substantially covers the initial fair value of the leased asset and lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years). Therefore, it constitutes a finance lease.

iii) **Computation of Unearned Finance Income**

	Rs.
Total lease payments (Rs.3,06,593 x 3)	9,19,779
Add: Unguaranteed residual value	50,000
Gross investment in the lease	9,69,779
Less: Present value of investment (lease payments and residual value) (37,565 + 7,62,435)	(8,00,000)
Unearned finance income	**1,69,779**

Q12. (July. 21 – 4 Marks)

Ted entered into a lease contract with lessor to lease 2,000 sqm of retail space for 5 years. The rentals are payable monthly in advance. The lease commenced on 1st April 2019. In the year 2020, as a direct consequence of Covid 19 pandemic, Ted has negotiated with the lessor which may results in the following situations:

- Lessor agrees a rent concession under which the monthly rent will be reduced by 30% per month for the 12 months commencing 1st October 2020.
- Ted is granted a rent concession by the lessor whereby the lease payments for the period October 2020 to December 2020 are deferred. Three months are added to the end of the lease term at same monthly rent.
- Lessor offers to reduce monthly rent by 50% for the months October 2020 to March 2021 on the condition that its space is reduced from 2,000 sq m to 1,500 sq m.

Analyze the given situations in the light of Ind AS 116 and comment on whether rent concession/deferral is eligible for practical expedient?

SOLUTION

Applicability of practical expedient:

The practical expedient applies only to rent concessions occurring as a direct consequence of the covid-19 pandemic.

As a practical expedient, a lessee may elect not to assess a rent concession as a lease modification only if all of the following conditions are met:

(a) the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;

(b) any reduction in lease payments affects only payments originally due on or before the 30th June, 2021; and

(c) there is no substantive change to other terms and conditions of the contract

Analysis:

Based on above guidance, answer to the given situations with the lessor would be as follows:

1. **Lessor agrees a rent concession under which the monthly rent will be reduced by 30% per month for the 12 months commencing 1st October 2020:**

The rent deferral does not satisfy the criteria to apply the practical expedient because out of the listed eligibility criteria given in Ind AS 116, rent concession reduces lease payments starting from October, 2020 and reduction will continue till September, 2021 which is beyond 30th June 2021. Therefore, Ted is not permitted to apply the practical expedient.

2. ***Ted is granted a rent concession by the lessor whereby the lease payments for the period October 2020 to December 2020 are deferred. Three months are added to the end of the lease term at same monthly rent:***

   (a) *condition is met since revised consideration in the lease is substantially the same as the original*

   (b) *condition is met since the rent concession only reduces lease payments originally due in 2020 – i.e. before 30th June 2021.*

   (c) *condition is met since the lessee assesses that three-month extension at the end of the lease term is with substantially the same lease payments. Hence, it would not constitute a substantive change.*

Since, the rent concession is a direct consequence of COVID-19 and all three conditions are met, rent concession is eligible for application of practical expedient in this case.

3. ***Lessor offers to reduce monthly rent by 50% for the months October 2020 to March 2021 on the condition that its space is reduced from 2,000 sqm to 1,500 sqm:***

The rent concession does not satisfy the criteria to apply the practical expedient because out of the listed eligibility criteria given in Ind AS 116, there is a substantive change to the terms and conditions of the lease as there is a change in the scope of lease by reducing the space from 2,000 sqm to 1,500 sqm. Therefore, Ted is not permitted to apply the practical expedient.

Q13 (December 21 – 10 Marks)

- *Jakob ltd. entered into a contract for lease of retail store with Entity J on January 01/01/2018. The initial term of the lease is 6 years with a renewal option of further 2 years. The annual payments for initial term and renewal term is Rs 2,80,000 and Rs 3,50,000 respectively.*
- *The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 01/01/2019 will be based on the CPI available at 31/12/2018.*
- *Jakob Ltd's incremental borrowing rate at the lease inception date and as at 01/01/2021 is 8% and 10% respectively and the CPI at lease commencement date and as at 01/01/2021 is 250 and 260 respectively.*
- *At the lease commencement date, Jakob Ltd did not have a significant economic incentive to exercise the renewal option. In the first quarter of 2021, Jakob Ltd installed unique lease improvements into the retail store with an estimated five-year economic life.*
- *Jakob Ltd determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.*

Is Jakob Ltd required to remeasure the lease in the first quarter of 2021?

Suggested Solution:

(ICAI's Suggested answer were not released till finalization of this book)

Since Jakob Ltd is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 2021.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	5 years; 3 years remaining in the initial term plus 2 years in the renewal period
Entity W's incremental borrowing rate on the remeasurement date	10%
CPI available on the remeasurement date	260
Right-of-use asset immediately before the remeasurement	6,99,019 (Refer note 1)
Lease liability immediately before the remeasurement	7,79,016 (Refer note 1)

Procedure to re-measure the lease liability:

To remeasure the lease liability, Jakob Ltd would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 10%).

The following table shows the present value of the future lease payments based on an updated CPI of 260. Since the initial lease payments were based on a CPI of 250. As a result, Jakob Ltd would increase the future lease payments by 4%.

Computation of present value of the future lease payments based on an updated CPI of 260:

Year	4	5	6	7	8	Total
Lease Payment	291200	291200	291200	364000	364000	1601600
Discount @ 10%	1	0.909	0.826	0.751	0.683	
Present value	291200	264701	240531	273364	248612	1318408

To calculate the adjustment to the lease liability, Jakob Ltd would compare the recalculated and original lease liability balances on the re-measurement date:

Revised lease liability	13,18,408
Original lease liability	7,79,416
	538991

Based on above calculations, it is clear that re-measurement of lease is required and accordingly adjustment to lease liability and ROU asset is required in the 1st quarter of 2021.

Jakob Ltd would record the following journal entry to adjust the lease liability.

ROU Asset	Dr.	538991	
To Lease liability			538991
Being lease liability and ROU asset adjusted on account of remeasurement.			

Working Notes:

1. **Calculation of ROU asset before the date of remeasurement**

Year Beginning	Lease payment (A)	Present value @ 8%	Present value of lease payments (A x B=C)
1	2,80,000	1.000	2,80,000
2	2,80,000	0.926	2,59,280

3	2,80,000	0.857	2,39,960
4	2,80,000	0.794	2,22,320
5	2,80,000	0.735	2,05,800
6	2,80,000	0.681	1,90,680
Lease liability as at commencement date			**13,98,040**

or

(2,80,000 x Sum of PV (4.993) @ 8% for 5 years = 13,98,040)

2. Calculation of Lease Liability and ROU asset at each year end

Year	Lease liability				ROU Asset		
	Initial value	Lease payment	Interest expense @ 8%	Closing balance	Initial value	Depreciation for 6 years	Closing balance
1	13,98,040	2,80,000	89,443	12,07,483	13,98,040	2,33,007	11,65,033
2	12,07,483	2,80,000	74,199	10,01,682	11,65,033	2,33,007	9,32,026
3	10,01,682	2,80,000	57,735	7,79,416	9,32,026	2,33,007	6,99,019
	7,79,416				**699019**		