Transition to Ind AS 116 Leases

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29th June 2019

Agenda

1. Setting the context
2. What is changing
3. Transition option

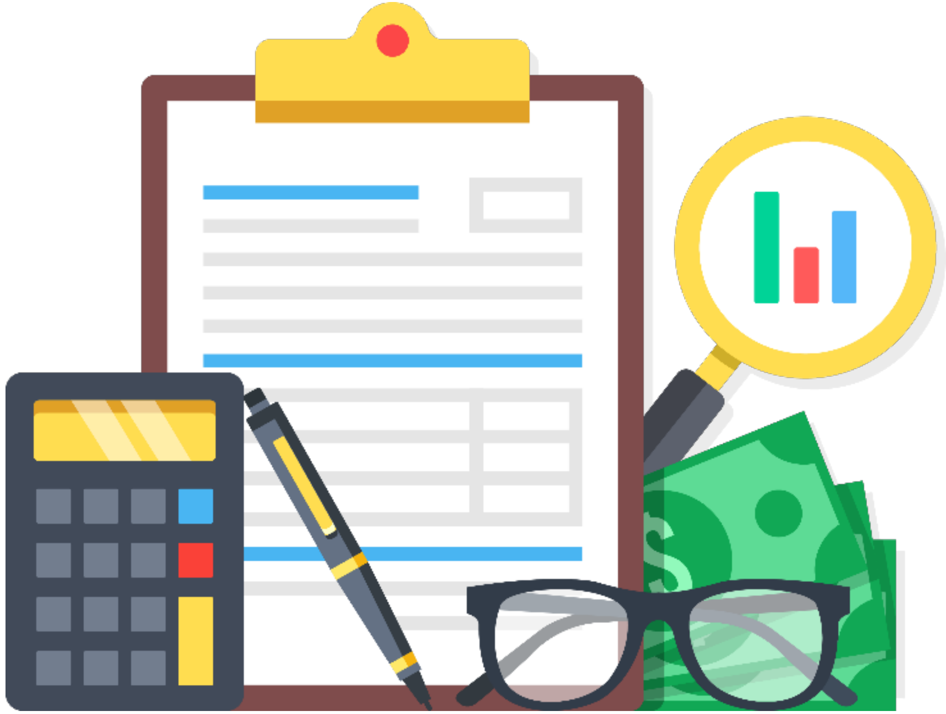
Setting the context

Background

- New leasing standard – effective for periods beginning on or after **1 April 2019 (1 January 2019 for IFRS 16)**
- Standard developed in conjunction with the FASB. FASB and IASB issued their respective standards in the first quarter of 2016 with the primary objective of bringing all leases onto the balance sheet. It was intended to be a converged standard, however, there a number of differences between IFRS 16 and ASC 842

Supersedes

- IAS 17/ Ind AS 17, Leases
- IFRIC 4 Determining whether an Arrangement contains a Lease
- SIC-15 Operating Leases: Incentives, and
- SIC-27 Evaluating the Substance of Transactions involving the Legal Form of a Lease



Highlights

- New lease model and revised definition of a lease
- Most leases brought on-balance sheet for lessees
- Lessor accounting largely unchanged
- Partial convergence with U.S. GAAP achieved

Shift in leasing principles

Ind AS 17	**Ind AS 116**
Risk and rewards model	Control model

Ind AS 116 Vs Ind AS 17 changes

- The finance lease/operating lease distinction under Ind AS 17 is no longer relevant under Ind AS 116 for lessees. Instead, most leases will have to be recognised as "right-of-use" asset with a related liability, with subsequent accounting similar to the finance lease model under Ind AS 17.
- Rental expense in case of operating lease will be replaced by depreciation charge and finance cost

Applicability & timelines

	IFRS/US GAAP transition January 1, 2019 *	Ind AS transition April 1, 2019	Q1 reporting (Numbers) July – August 2019 * (for QE Jun '19)	March 31, 2020 (Numbers & Disclosures) Apr – Mar '20 (for YE Mar '20)
Listed Companies & their components (Other than Banks & Insurance Companies)	✓	✓	✓	✓
Unlisted Companies (Ind AS) *	✓	✓	✗	✓
Unlisted Companies (Group Covered) **	✓	✗	✗	✗
Banks (for proforma Ind AS reporting) #	✓	✓	✓	✓

* Companies having net worth >250 crores.
** Reporting will be as per the global financial year end date
# Considering the banks are publishing results in US GAAP and IFRS

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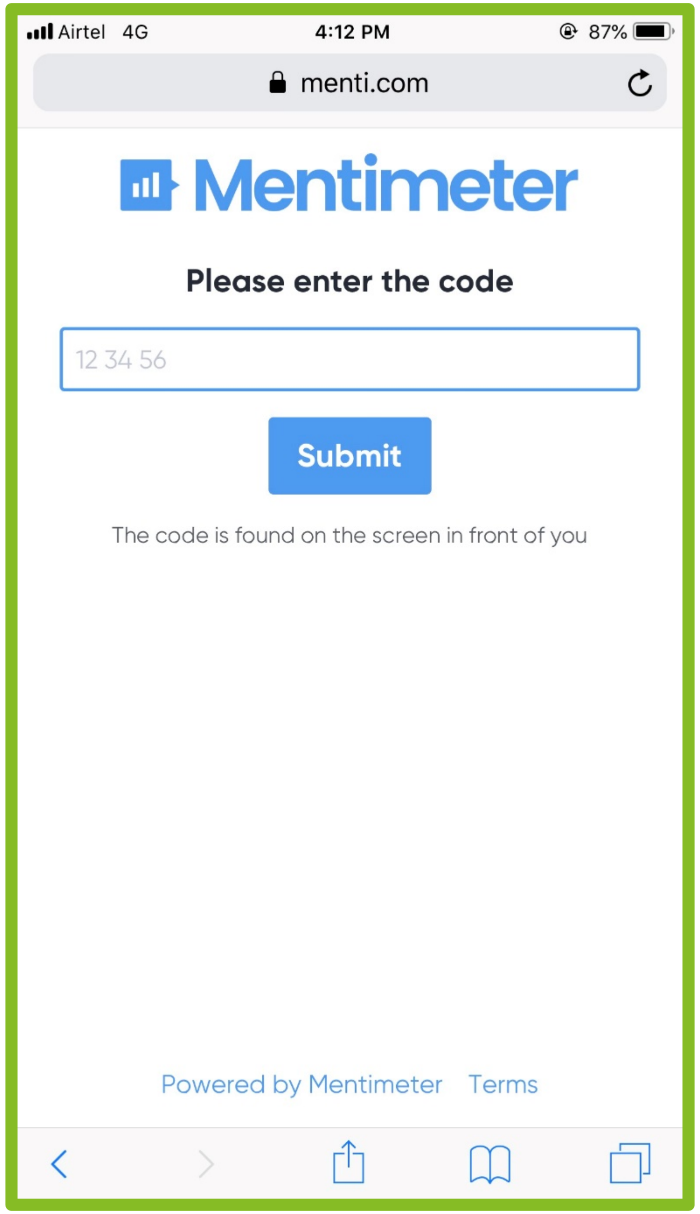

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Polling question 1
How will the adoption of the new Leases Standard affect financial reporting?

- ❑ Material changes expected
- ❑ Limited changes expected
- ❑ No changes expected
- ❑ Unknown

What’s new

A summary of changes

The Ministry of Corporate Affairs introduced Indian Accounting Standards (Ind AS) 116, replacing Ind AS 17 Leases, starting 1 April 2019

Impact for lessee

Lessees to bring virtually all leases onto the balance sheet, applying the “right of use asset” model and recognise a corresponding liability for future lease payments

Impact for lessor

The accounting remains largely unchanged, except in case of sub-leases

Balance sheet

	Ind AS 17		Ind AS 116
	Finance Leases	Operating Leases	All Leases
Assets		-----	
Liabilities	₹	-----	₹ ₹ ₹
Off balance sheet rights /obligations		₹ ₹	

Income statement

	Ind AS 17		Ind AS 116
	Finance Leases	Operating Leases	All Leases
Revenue	X	X	X
Operating costs (excl. depreciation & amortisation)	------	Single expense	-----
EBITDA			↑↑
Depreciation & amortisation	Depreciation	-----	Depreciation
Operating Profit			↑
Finance costs	Interest	-----	Interest
Profit before tax			↔

Financial impact

Profit / Loss	EBITDA	↑
	EPS / PBT (in early years)	↓
Balance Sheet	Total assets	↑
	Net assets	↓
Ratios	Gearing	↑
	Interest cover	↓
	Asset turnover	↓

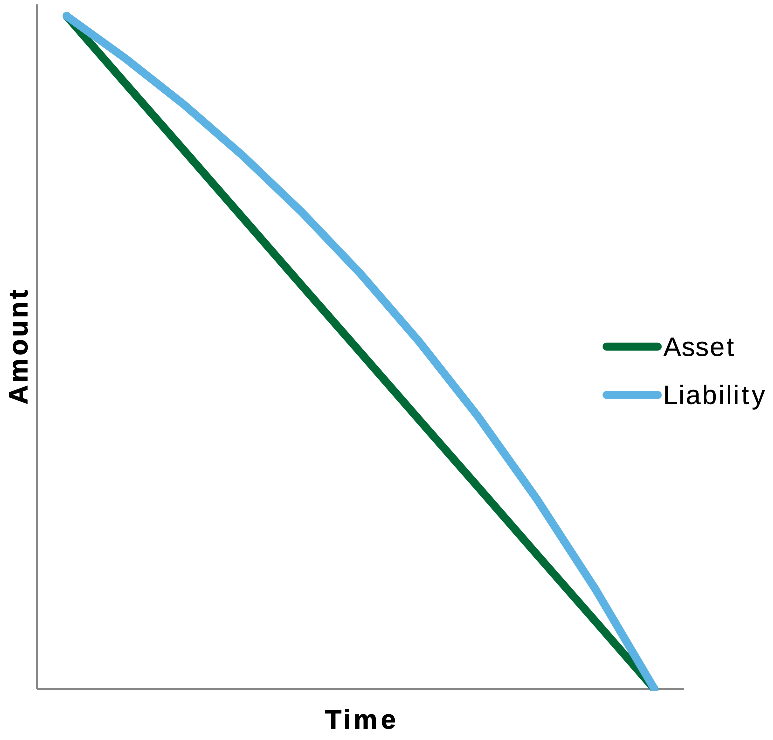
Process & Control Redesigning of RCM (ICFR)

Dividend, MR, Bonuses, Earn Out, CAR

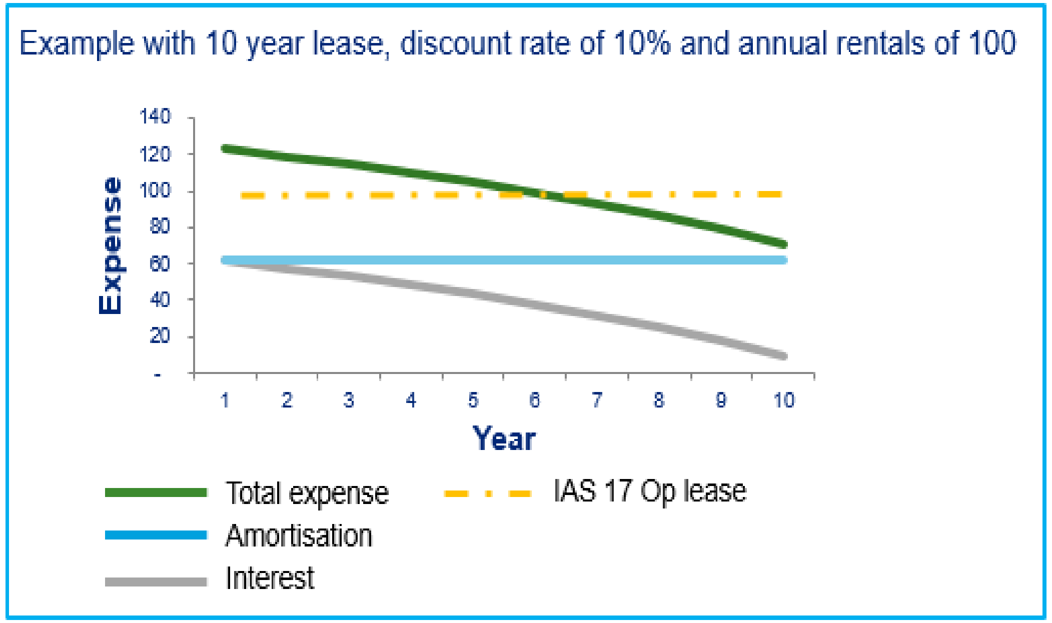
Charts were excerpted from the IASB’s IFRS 16 Effects Analysis

Lease accounting - visualization

Balance sheet



Income statement



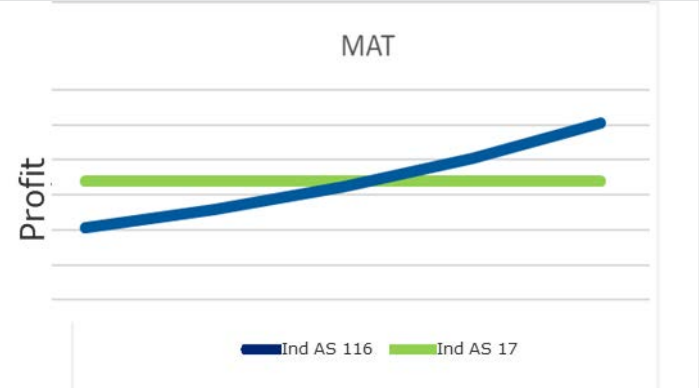
The expense recorded in the income statement each year will decrease over the course of the lease lifetime. This may have an impact on covenants, KPIs.

Taxation

Tax

- Impact on transfer pricing
- No ICDS on leases notified yet
- Litigations to continue

- Company might pay lower MAT in the initial years and higher in the latter years.
- No guidance on Transition adjustments



MAT

Deferred Tax

- Recognition of ROU asset and Lease liability will result in difference between tax base and accounting bases
- DTA / DTL creation and reversal to be computed and accounted for

Potential impact of the standard

Transition Approach	Who has opted? (group level)	Impact on Assets ⬆	Impact on Liabilities ⬆
Retrospective	TESCO#	£7,527m	£10,272m
	Unilever^	€1.7 billion	€1.9 billion
Modified Retrospective	Fiat Chrysler Automotive N.V.^	EUR 1.3 billion	EUR 1.3 billion
	Brookfield Property Partners L.P.^	USD 970 million	USD 973 million
	British American Tobacco p.l.c^	GBP 565 million	GBP 562 million
	Union Pacific Corporation^	$2 bn	$2 bn
	TCS*	INR 5,623 crore	INR 6,555 crore
	Infosys*	INR 2,300 crore	INR 3,050 crore
Modified Simplified	Tenaris SA^	USD 260 million	USD 260 million
	Ferrari N.V.^	EUR 62 million	EUR 62 million
	A. P. Moller Maersk^	$6 bn	$6 bn

*These numbers indicate the approximate impact to the Mar'19 year ended balance sheet

^These numbers indicate the approximate impact to the Dec 2018 year ended balance sheet

#These numbers indicate the approximate impact to the Feb'18 52 weeks balance sheet

Potential impact of the standard (cont'd)

An industry overview

Industry	What's coming in?	Key Challenges
Airlines	Aircrafts, Kiosks, hangers	Foreign currency Lease liability translation
Retail	Retail outlets, storage facilities, supply chain	Lease & Non-Lease component bifurcation, impact on balance sheet
Energy	Power plants	Lease assessment
Telecom	Mobile towers, outlets, fibre optic cables	Volume of leases, identification of leases in tower
Financial Services	Corporate office, ATM machines, printing kiosks	Changes in Capital Ratios - recalibration of risk models, acceptance by governing bodies
Information Technology	Cloud servers	Separation of hardware support and personnel assistance

What is changing

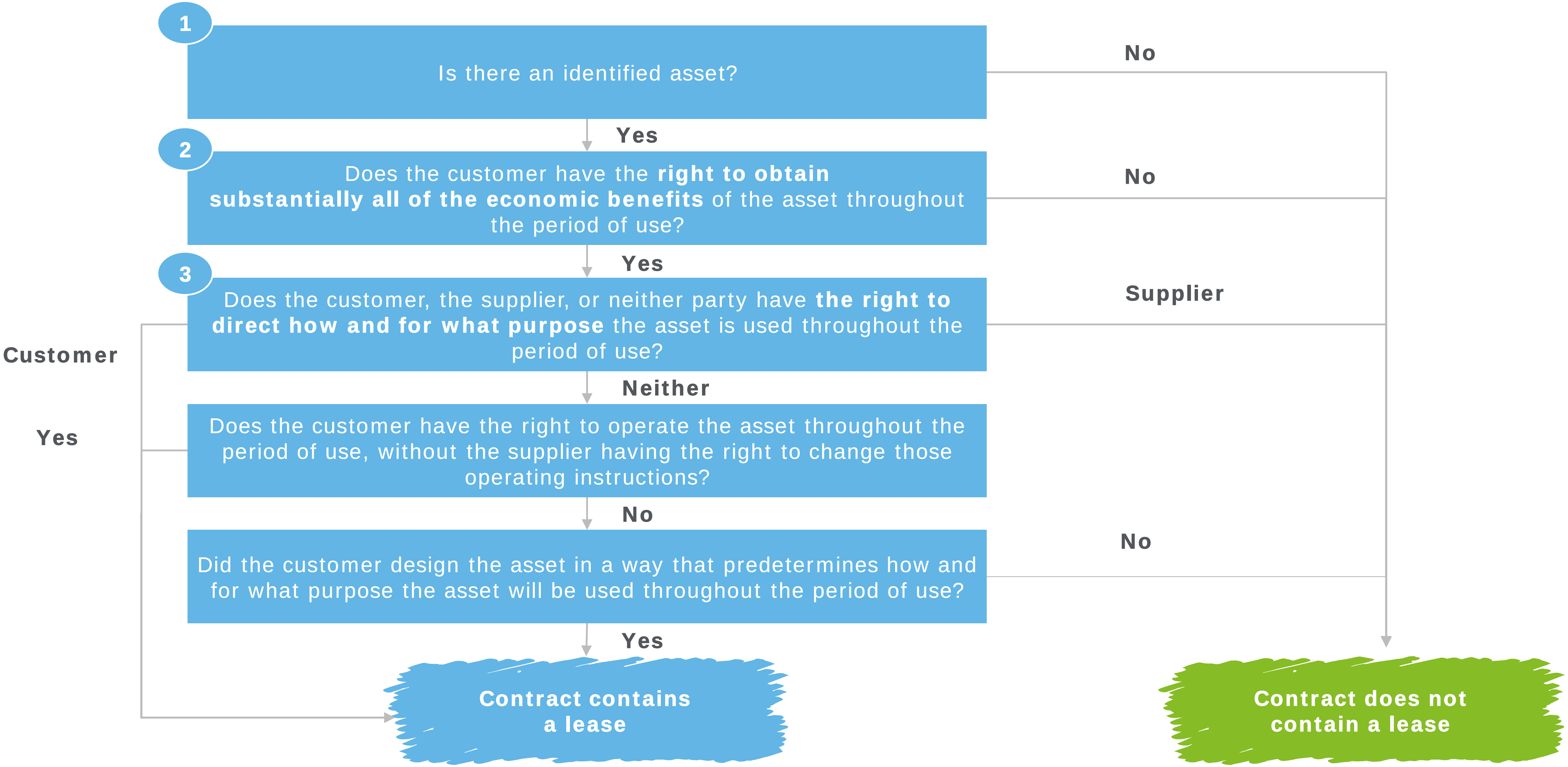
Lease definition

Contract, or part of a contract, conveys the right to control the use of an identified asset for a period of time in exchange for consideration

Control

Substitutability

Lease definition - overview



Example

Identifying a lease contract

- Customer A enters into a contract with Company B for the exclusive use of a refrigerated storage unit for a 15-month period. Company B constructed the storage unit and is responsible for operating and maintaining it.
- The contract explicitly identifies the storage unit via its serial number, and B is contractually restricted from substituting the refrigerated storage facility during the contract term. Therefore, the parties have determined that the fulfillment of the contract depends on an identified asset.
- Throughout the 15-month period of use, A has the right to take products out of, or put them into, the storage unit at any time without B's consent. However, B controls physical access to the storage unit and only B's employees are allowed inside; therefore, B is responsible for physically moving the products as A requests.

Question: Does Contract contain a lease?

Yes, Customer A has the right to obtain substantially all of the economic benefits from the storage unit throughout the 15-month period of use because of its exclusive use of the storage unit.

Although B controls physical access to the storage unit and is responsible for operating it, B does so according to A's decisions about **what** products will be stored in the storage unit as well as **whether** and, if so, **when** they will be stored.

Customer A therefore has the right to direct the use of the storage unit. Because A obtains substantially all of the economic benefits from the storage unit (an identified asset) and has the right to direct its use, the contract contains a lease.

Lease recognition exemptions

Two major optional exemptions make the standard easier to apply

Exemptions not available for lessors

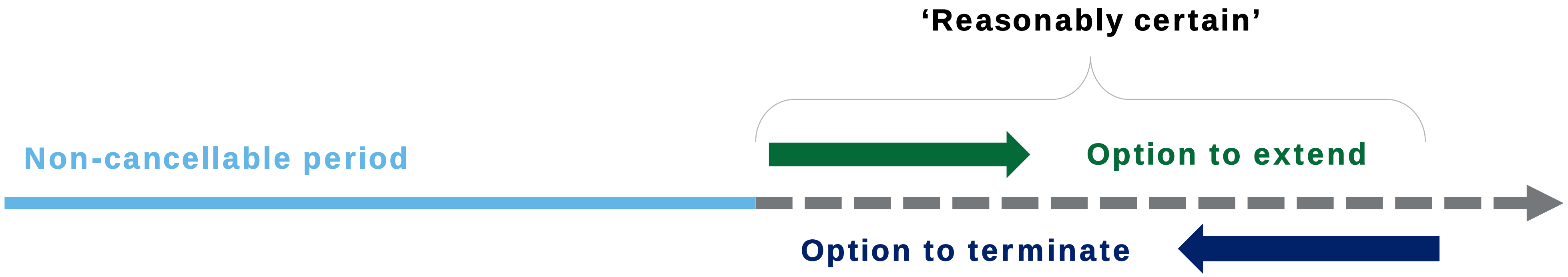
Short term leases

- ≤ 12 months and no purchase option
- Election of exemption shall be made by class of underlying asset
- The lessee shall consider the lease to be a new lease if :
  1. There is a lease modification; or
  2. There is a change in lease term

Leases of low value items

- ≤ USD 5,000 for example and not subject to sublease
- Election of exemption shall be made on lease by lease basis
- Value of the underlying asset shall be assessed when it is new
- Exemption available regardless of whether the asset is material to the lessee.
- eg,. Telemarketing firms that lease large number of telephones

Lease Term



Includes period covered by the option to terminate the lease held by the lessor

Consider all facts and circumstances that create an **economic incentive**, including expected changes:

- Contractual terms for optional periods e.g. lease rent, termination penalties, residual value guarantees
- Significant leasehold improvements
- Costs of termination and return e.g. negation cost, relocation cost, termination penalties, cost of identifying alternative asset and integrating it with the operations
- Importance to operations (specialised, location, alternatives)
- Conditionality associated with option

Sectors impacted:

1) Transport and logistics – economic incentive to renew leases
2) Retailers - economic incentive to renew leases

- ➢ Other contractual features i.e. guarantee of minimum fixed return
- ➢ Shorter the non cancellable period, higher the cost of replacement
- ➢ Past practice and economic reasons for the same

Example

Assessment of Lease Term

A customer is considering entering into a lease for equipment to manufacture tyres. The lease has a 5 year term, with an option exercisable by the lessee only to extend the lease for an additional 2 years. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional 2 year period if the lessee exercises its extension option. The customer operates in a remote location where the cost of shipping and installation for pieces of equipment are significant.

Assessment: Following relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered:

- costs the customer would incur to obtain a suitable replacement asset,
- the importance of the asset to the customer's operations,
- the availability of suitable replacement assets

Considering above it may be concluded that it is reasonably certain that the extension option will be exercised and therefore the lease term is estimated on commencement of the lease to be 7 years.

Lease and non lease components

Identify separate lease components

1. The lessee can benefit from using the underlying asset either on its own or together with other resources that are readily available and
2. The asset is neither highly dependent on nor inter-related with the other assets in the contract

Account for each component separately

Sectors impacted:

1) Transport and logistics – lease of vehicles combined with maintenance, insurance
2) Retailers - need to separate service charges (e.g. administrative/utilities/marketing) from lease elements.
3) Telecommunication

Contract

Lease components	Non-lease components	Not a component
Allocate consideration in the contract		Activities (or lessor costs) that do not transfer goods or services to the lessee

Example

Identifying lease and non-lease components

- Company B enters into an office space lease for 5 years with Property Co.
- Contract requires maintenance services to be provided by Property Co.
- Annual payments are INR 200,000.
- Similar maintenance service are offered separately by third parties for INR 44,000 a year.
- Market rental rate for a similar office block without maintenance services is INR 176,000.

Q: How would Company B estimate the lease payments?

Performance obligation	Stand-alone price	Selling price ratio	Price allocation	
Lease	$1,760	80%	$1,600	($2,000 X 80%)
Maintenance services	$ 440	20%	$ 400	($2,000 X 20%)
	$2,200		**$2,000**	

Practical expedients

Separating lease vs. non-lease components	• Ind AS 116 only requires lessees to bring the leasing component of a contract on-balance sheet; any payments for services such as maintenance are expensed as incurred • Allocation between the lease and service components is made on the basis of relative stand-alone prices → may require considerable **judgment** to estimate • **Lessees can elect to treat entire contract as a single lease, removing the need for an unbundling exercise but increasing the liability**

Measuring lease liability

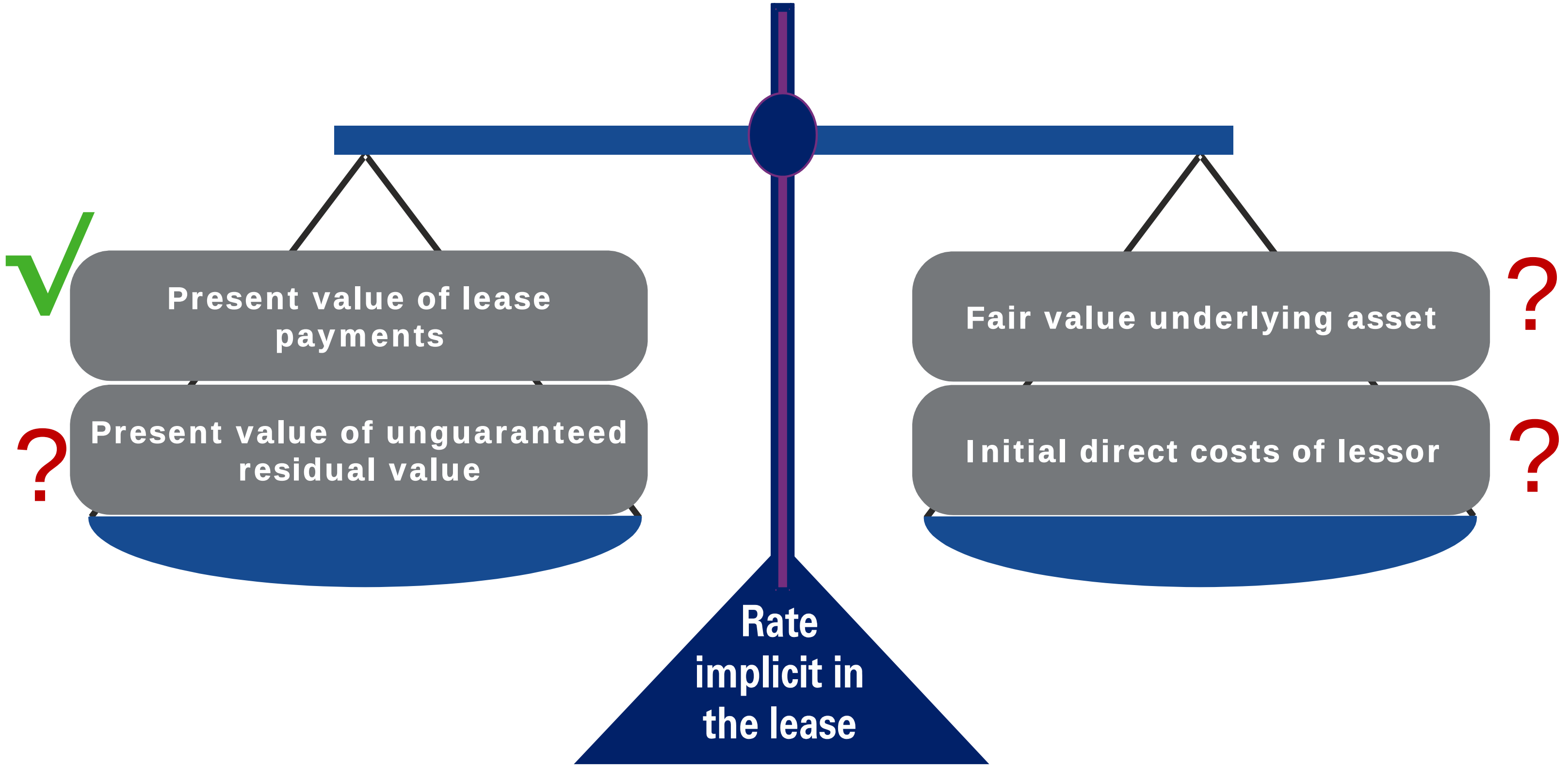
Lease liability = Present value of remaining lease payments + Present value of expected payments at end of lease

Types of lease payments

- fixed payments (including in-substance fixed payments), less any lease incentives receivable
- Variable lease payments that depend on an index or a rate
- Amounts expected to be payable by the lessee under residual value guarantees
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Implicit rate of return versus incremental borrowing rate

The rate implicit in the lease, if readily available | **OR** | **The lessee's incremental borrowing rate**



Practical expedients

Portfolio	• Lease portfolios with similar risk characteristics may be accounted for on a portfolio basis using estimates and assumptions for the portfolio, if it is not expected to result in materially different accounting • Likely to apply to leases for items such as vehicles where they are all part of a master agreement • However, it may be difficult to use the portfolio approach due to differing counterparties, dates, terms, etc. which may result in materially different cash flow implications

Right of use asset (ROU)

Right of use asset

- the amount of the initial measurement of the lease liability
- any lease payments made at or before the commencement date, less any lease incentives received
- any initial direct costs incurred by the lessee
- ARO - an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease

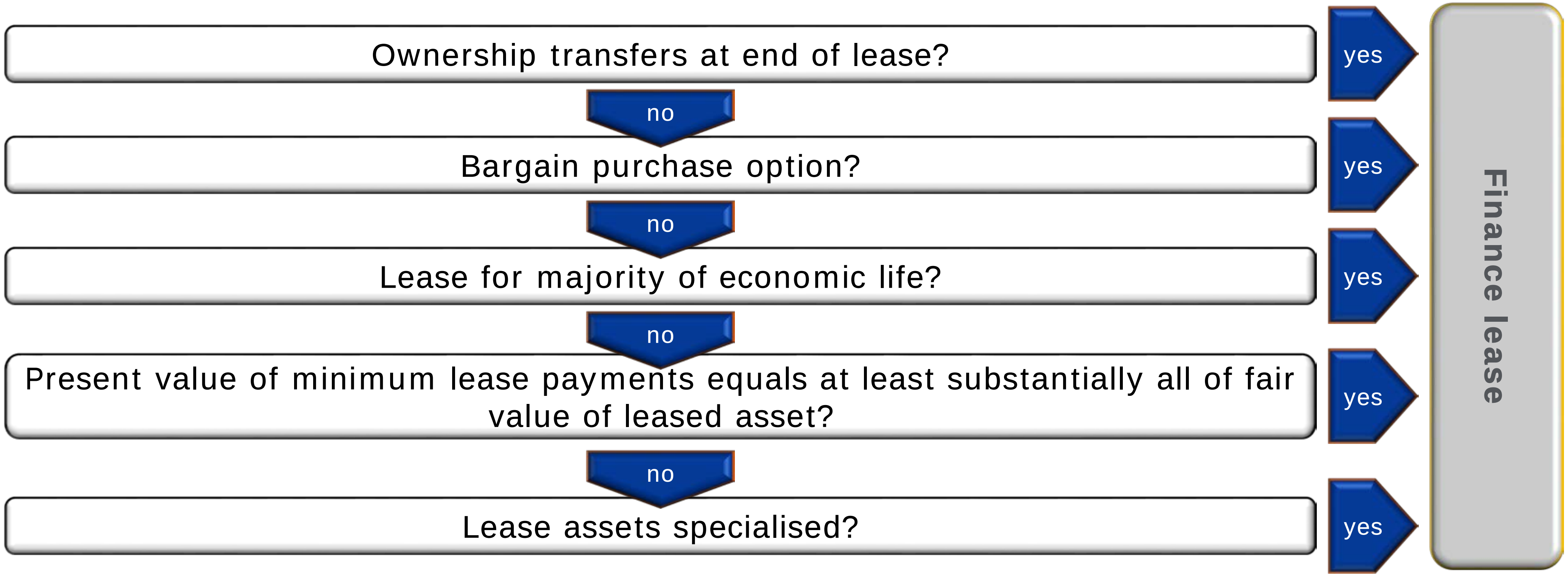
ROU and Lease Liability

Subsequent measurement

Lease liability	Amortised cost using the effective interest method – financial liability
ROU asset (cost model)	• Depreciated in accordance with Ind AS16 *Property, Plant & Equipment*. • Depreciation period is the shorter of lease term/useful life. • Impairment testing under Ind AS 36 *Impairment.*
ROU asset (alternative models)	• Revaluation model under Ind AS 16.

Lessor accounting

Same as Ind AS 17	Different to Ind AS 17
• Lease classification test. • Finance lease model. • Operating lease model.	• Definition of a lease. • Sub-lease guidance. • Accounting for lease modifications. • Disclosure requirements.



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Polling question 2
How do you rate the complexity of the following areas from an implementation perspective?

- ❑ Calculate lease liability & ROU asset
- ❑ Determining Lease term
- ❑ Determining the discount Rate
- ❑ Determining Lease contract Vs Service contract

Spreadsheets can handle this…right?

Challenges in a spreadsheet approach to Ind-AS 116

- Extremely complex calculations to arrive at lease liability and ROU
- Selection of transition option requires 3X calculation for all leases
- Changes in lease terms result in recalculation of interest cost and depreciation and requires disclosure
- Inherent weakness of a spreadsheet to handle large volumes of data which affects processing speed and causes system crashes

What to look for in technology enabled lease accounting

- Ability to address all types of lease related variations. Our experience shows ~ 60 different scenarios
- Workflow solution with maker-checker concept to ensure compliance with Internal Control reporting requirements
- Clear audit trail to identify nature and source of changes in lease details
- Ability to generate year-end Notes to Accounts disclosures apart from monthly JVs, MIS reports pertaining to leases and
- Customizable to individual company needs for data capture and reporting

Ok…I'm sure my ERP can do it

ERPs

- Single source of truth
- Ability to integrate from creation of PO to lessor payment to lease accounting entries
- Zero manual intervention after creation of lease and no need for any reconciliation

- Cannot handle complexities like index/ rate based escalations, incentives received, GRV, initial direct cost, non-refundable security
- Does not form part of the standard stack, requires purchase of additional modules
- Any customization requires coding skills

Bespoke solutions

- Purpose built for lease management and lease accounting - catering to most complexities in an agreement
- Economical, especially for immediate use to transition
- Basic customizations can be done during deployment
- Year-end disclosures are pre-built

- Absence of direct integration with ERP
- Data needs to be captured two times and could lead to reconciliation differences

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Polling question 3
What kind of technology solution do you use / intend to use for managing Lease Accounting?

- ❑ My current ERP
- ❑ Bespoke / Off-the-shelf lease accounting tools
- ❑ Microsoft Excel / Google Sheets
- ❑ Yet to decide

Transition Options

Transition options

1. Practical expedient on transition date to grandfather their previous assessment of which existing contracts is or contains lease

2. **Lessees** are permitted to choose between two transition approaches applied consistently to all leases – (a) Full retrospective; and (b) Modified retrospective.

Transition Options

Option 1 – Retrospective

Restate comparatives as if Ind AS 116 always applied

Option 2 – Modified

- Difference between asset and liability recognised in opening RE at transition date.
- *Operating Leases:*
  - Calculate present value of remaining lease payments for existing operating leases using incremental borrowing rate at date of transition.
  - Choose how to measure ROU asset on **lease-by-lease basis:**

Option 2A

Measure asset as if Ind AS 116 had been applied from lease commencement (but using incremental borrowing rate at date of transition)

Option 2B

Measure asset at amount equal to liability (adjusted for accruals and prepayments)

Practical expedients

(a) **Single discount rate -** a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

(b) **Short term lease exemption - l**eases for which the lease term ends within 12 months to be considered as short term leases

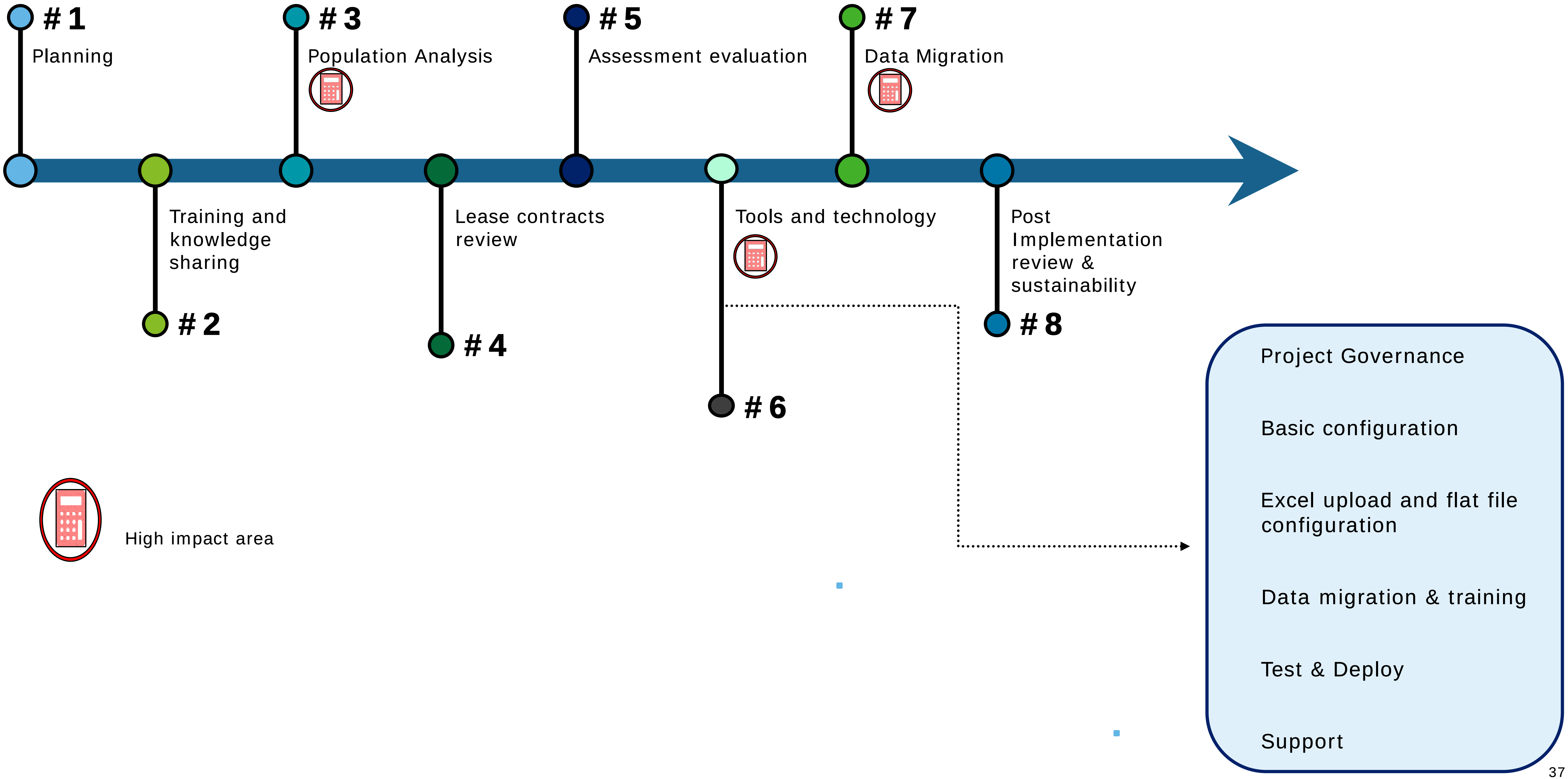
(c) **Initial Direct cost -** a lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

(d) **Hindsight -** a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

(e) **Onerous contracts -** a lessee may rely on its assessment of whether leases are onerous applying Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, immediately before the date of initial application as an alternative to performing an impairment review.

The above options are available on a lease by lease basis

Implementation journey



Questions & answers

Thank You

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