

Ind AS 116: Leases

Section A – Practical & Relevant Theory Questions

Accounting of Lease in Lessee's Books

Question 1

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on 1st January, 20X1:

- The lease commencement date is 1st February, 20X1.
- Entity Y must pay Entity Z the first monthly rental payment of ₹ 10,000 upon execution of the lease.
- Entity Z will pay Entity Y ₹ 50,000 cash incentive to enter into lease payable upon lease execution.

Entity Y incurred ₹ 1,000 of initial direct costs, which are payable on 1st February, 20X1. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹ 8,50,000.

How would Lessee Company measure and record right-of-use asset in this lease?

Answer

Entity Y would calculate the right-of-use asset as follows:

₹

Initial measurement of lease liability	8,50,000
Lease payments made to Entity Z before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	1,000
Initial measurement of right-of-use asset	8,11,000

Question 2

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 1,00,000. Lease payments will increase by the rate of SOFR (Secured Overnight Financing Rate) each year. At the date of commencement of the lease, SOFR is 2 percent.

Assume that the interest rate implicit in the lease is 5 percent. How is lease liability initially measured?

Answer

In the given case, the lease payments depend on a rate (i.e., SOFR) and hence is included in measuring lease liability. As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. SOFR) as at the commencement date. SOFR at that date is 2 percent; therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 percent, as follows:

Year Beginning	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	1,00,000
2	1,02,000	0.952	97,104
3	1,04,040	0.907	94,364

4	1,06,121	0.864	91,689
5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012
8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	77,083
			8,80,889

Therefore, the present value of lease liability initially will be measured at ₹ 8,80,889.

Question 3

Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the end of each year:

₹ 20,000 in year one

₹ 30,000 in year two

₹ 50,000 in year three

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assume a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC would account for the said lease under Ind AS 116? Pass necessary journal entries for the 1st year.

Note: Take PV Factor in 4 decimals

Answer

At the commencement date, Entity ABC would **initially recognise** ROU Asset and the corresponding Lease Liability of ₹ 77,364 which is calculated as follows:

Year	Payments (Cash flows)	Discounting Factor @ 12%	Present Value
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916
3	50,000	0.7118	35,590
	1,00,000		77,364

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	Opening balance	Interest Expense	Payments	Closing balance
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	–

*Difference of ₹ 4 is due to approximation

ROU Asset (assuming no lease incentives, no initial direct costs, etc.)

Year	Opening balance	Depreciation	Closing balance
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

At lease commencement, Entity ABC would **recognise** the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset	Dr.	₹ 77,364	
To Lease Liability			₹ 77,364
(To initially recognise the Lease Liability and the ROU Asset)			

The following journal entries would be recorded in the first year:

Interest Expense	Dr.	₹ 9,284	
To Lease Liability			₹ 9,284
(To record interest expense and accrete the lease liability using the effective interest method) (₹ 77,364 x 12%)			
Depreciation Expense	Dr.	₹ 25,788	
To ROU Asset			₹ 25,788
(To record interest expense and accrete the lease liability using the straight line method) (₹ 77,364/3 years)			
Lease Liability	Dr.	₹ 20,000	
To Bank			₹ 20,000
(To record lease payment)			

Following is summary of said lease contract's accounting (assuming no changes due to reassessment):

Particulars	Initially	Year 1	Year 2	Year 3
Cash lease payments		20,000	30,000	50,000
<u>Lease Expense Recognised</u>				
Interest Expense		9,284	7,998	5,354
Depreciation Expense		25,788	25,788	25,788
Total Periodic Expense		35,072	33,786	31,142
<u>Balance Sheet</u>				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

Question 4

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 ₹ 50,00,000. Company EFG has an option to purchase the property at the end of the lease term for ₹ 30,00,000. The first advance annual payment is ₹ 5,00,000 with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of ₹ 2,00,000

(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? Pass necessary journal entry on lease commencement date.

Note: Take PV Factor in 2 decimals

Answer

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)	₹ 37,39,648
PV of purchase option at end of lease term (W.N. 2)	₹ 12,60,000
Total lease liability	₹ 49,99,648

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 record the following **journal entry on the lease commencement date**:

Right-of-use Asset	Dr.	₹ 49,99,648	
To Lease Liability			₹ 49,99,648
(To record ROU asset and lease liability at 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 ₹ 1,24,991 (₹ 49,99,648/40 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 beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year)
	a	b = a - c	c = (d of previous year)	d = [(e of previous year - a) × 9.04%]	e = (e of previous year + d - a)
Commencement					49,99,648
Year 1	5,00,000	5,00,000	–	4,06,768	49,06,416
Year 2	3,15,000*	(91,768)	4,06,768	4,15,064	50,06,480
Year 3	5,30,450	1,15,386	4,15,064	4,04,633	48,80,663
Year 4	5,46,364	1,41,731	4,04,633	3,91,821	47,26,120
Year 5	5,62,754	1,70,933	3,91,821	3,76,368	45,39,734
Year 6	5,79,637	2,03,269	3,76,368	3,57,993	43,18,090
Year 7	5,97,026	2,39,033	3,57,993	3,36,384	40,57,448
Year 8	6,14,937	2,78,553	3,36,384	3,11,203	37,53,714

Year 9	6,33,385	3,22,182	3,11,203	2,82,078	34,02,407
Year 10	6,52,387	3,70,309	2,82,078	2,49,980 (B/f)	30,00,000
Year 10	30,00,000	27,50,020	2,49,980	–	–
Total	85,31,940	49,99,648	35,32,292	35,32,292	

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

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 Beginning	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 End	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 it's beginning of year 10 and in the later one its end of the year 10.

Accounting of Lease Remeasurement in Lessee's Books

Question 5

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 ₹ 56,000 per annum is payable in arrears. The Company recognized a lease liability of ₹ 3,51,613 at commencement date 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.

Answer

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 third year, Lessee remeasures lease liability at present value of eight payments of ₹ 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	$[(₹ 56,000/280) \times 301] = 60,200$	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 ₹ 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:

Particulars		₹	₹
Right-of-use asset	Dr.	22,854	
To Lease liability			22,854

Question 6

Entity W entered into a contract for lease of retail store with Entity J on January 1/1/20X1. The initial term of the lease is 5 years with a renewal option of further 3 years. The advance annual payments for initial term and renewal term are ₹ 1,00,000 and ₹ 1,10,000 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 1/1/20X2 will be based on the CPI available at 31/12/20X1.

Entity W's incremental borrowing rate at lease commencement date and as at 1/1/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 1/1/20X4 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the beginning of first quarter of 20X4, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W 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 Entity W required to remeasure the lease in the beginning of first quarter of 20X4? Pass necessary journal entry for remeasurement.

Answer

Since Entity W is now reasonably certain that it will exercise its renewal option, it is required to **remeasure the lease in the beginning of first quarter of 20X4.**

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	5 years; 2 years remaining in the initial term plus 3 years in the renewal period
Entity W's incremental borrowing rate on the remeasurement date	6%
CPI available on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	₹ 1,81,840 (Refer note 1)
Lease liability immediately before the remeasurement	₹ 1,95,244 (Refer note 1)

To remeasure the lease liability, Entity W would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4.167% approx. As a result, Entity W would increase the future lease payments by 4.167%. As shown in the table, the **revised lease liability** is ₹ 4,91,376.

Year	4	5	6	7	8	Total
Lease payment	1,04,167	1,04,167	1,14,583	1,14,583	1,14,583	5,52,083
Discount @ 6%	1	0.943	0.890	0.840	0.792	
Present value	1,04,167	98,230	1,01,979	96,250	90,750	4,91,376

To calculate the **adjustment to the lease liability**, Entity W would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	4,91,376
Original lease liability	(1,95,244)
	2,96,132

Entity W would record the following **journal entry to adjust the lease liability**.

ROU Asset	Dr.	2,96,132	
To Lease liability			2,96,132
(Being lease liability and ROU asset adjusted on account of remeasurement)			

Working Notes:

1. Calculation of Lease Liability and ROU asset before the date of remeasurement

Year beginning	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
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1	1,00,000	1.000	1,00,000
2	1,00,000	0.952	95,200
3	1,00,000	0.907	90,700
4	1,00,000	0.864	86,400
5	1,00,000	0.823	82,300
Lease liability as at commencement date			4,54,600

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense	Closing balance	Initial Value	Depreciation	Closing balance
1	4,54,600	1,00,000	17,730	3,72,330	4,54,600	90,920	3,63,680
2	3,72,330	1,00,000	13,617	2,85,947	3,63,680	90,920	2,72,760
3	2,85,947	1,00,000	9,297	1,95,244	2,72,760	90,920	1,81,840
4	1,95,244				1,81,840		

Accounting of Lease Modification in Lessee's Books

Question 7

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

Answer

In the given case, Lessee calculates the lease liability before modification as follows:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A + B - C]
1	7,35,900	44,154	1,00,000	6,80,054
2	6,80,054	40,803	1,00,000	6,20,857
3	6,20,857	37,251	1,00,000	5,58,108
4	5,58,108	33,486	1,00,000	4,91,594
5	4,91,594	29,496	1,00,000	4,21,090
6	4,21,090			

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

- a five-year remaining lease term,
- annual payments of ₹ 95,000, and

(c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825
2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	67,735
			3,89,500

Lessee recognises the **difference** between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an **adjustment to the ROU Asset**.

Working Note: Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200
5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	55,800
Initial Lease liability			7,35,900

Question 8

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by another four years. The annual lease payments are unchanged (i.e., ₹ 1,00,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7% p.a.

How should the said modification be accounted for in the books of Lessee?

Answer

At the effective date of the modification (at the beginning of Year 7), Lessee **remeasures the lease liability** based on:

- (a) An eight-year remaining lease term
 (b) Annual payments of ₹ 1,00,000 and
 (c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

Working Notes:

1. Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
7	1,00,000	0.935	93,500
8	1,00,000	0.873	87,300
9	1,00,000	0.816	81,600
10	1,00,000	0.763	76,300
11	1,00,000	0.713	71,300
12	1,00,000	0.666	66,600
13	1,00,000	0.623	62,300
14	1,00,000	0.582	58,200
Modified lease liability			5,97,100

2. Calculation of Lease liability as at commencement date:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200
5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	55,800
Lease liability			7,35,900

3. Calculation of Lease liability immediately before modification date:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A + B - C]
1	7,35,900	44,154	1,00,000	6,80,054
2	6,80,054	40,803	1,00,000	6,20,857

3	6,20,857	37,251	1,00,000	5,58,108
4	5,58,108	33,486	1,00,000	4,91,594
5	4,91,594	29,496	1,00,000	4,21,090
6	4,21,090	25,265	1,00,000	3,46,355
Lease liability as at modification date				3,46,355

4. Adjustment to ROU asset:

Modified Lease liability	5,97,100
Original Lease liability as at modification date	(3,46,355)
Adjustment to ROU asset	2,50,745

The ROU asset will be increased by ₹ 2,50,745 on the date of modification.

Question 9

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the beginning of first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.

How should the said modification be accounted for in the books of lessee? Give journal entries for the same in the books of Lessee.

Answer

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

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 6%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 6%	d = a - b + c	e	f	g
1	3,67,950*	50,000	22,077	3,40,027	3,67,950	36,795	3,31,155
2	3,40,027	50,000	20,402	3,10,429	3,31,155	36,795	2,94,360
3	3,10,429	50,000	18,626	2,79,055	2,94,360	36,795	2,57,565
4	2,79,055	50,000	16,743	2,45,798	2,57,565	36,795	2,20,770
5	2,45,798	50,000	14,748	2,10,546	2,20,770	36,795	1,83,975
6	2,10,546				1,83,975		

*(refer note 1)

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 ₹ 30,000 and

(c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	23,520
Total			1,29,900

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the **difference** between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 - ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Journal Entry

Lease liability	Dr.	₹ 1,05,273	
To ROU Asset			₹ 91,987.50
To Profit and Loss			₹ 13,285.50

Lessee recognises the difference between the remaining lease liability of ₹ 1,05,273 and the modified lease liability of ₹ 1,29,900 (which equals ₹ 24,627) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Journal Entry

ROU Asset	Dr.	₹ 24,627	
To Lease liability			₹ 24,627

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	50,000	0.943	47,150
2	50,000	0.890	44,500
3	50,000	0.840	42,000
4	50,000	0.792	39,600
5	50,000	0.747	37,350
6	50,000	0.705	35,250
7	50,000	0.665	33,250
8	50,000	0.627	31,350

9	50,000	0.592	29,600
10	50,000	0.558	27,900
			3,67,950

Question 10

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

- include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and
- reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹ 1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for? Give journal entries for same in books of Lessee.

Answer

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 6%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
1	7,35,900*	44,154	(1,00,000)	6,80,054	7,35,900	(73,590)	6,62,310
2	6,80,054	40,803	(1,00,000)	6,20,857	6,62,310	(73,590)	5,88,720
3	6,20,857	37,251	(1,00,000)	5,58,108	5,88,720	(73,590)	5,15,130
4	5,58,108	33,486	(1,00,000)	4,91,594	5,15,130	(73,590)	4,41,540
5	4,91,594	29,496	(1,00,000)	4,21,090	4,41,540	(73,590)	3,67,950
6	4,21,090				3,67,950		

*Refer Note 4

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

- A three-year remaining lease term (i.e. till 8th year),
- Annual payments of ₹ 1,50,000 and
- Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments	Present value factor @ 7%	Present value of lease payments
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	(A)	(B)	(A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	1,22,400
Modified lease liability			3,93,600

The modified liability equals ₹ 3,93,600, of which

- (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 (Refer Note 1) and
- (b) ₹ 2,62,400 relates to the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3)

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950/5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (Refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability	Dr.	₹ 1,53,790	
To ROU Asset			₹ 1,47,180
To Gain			₹ 6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 [₹ 2,67,300 – ₹ 2,62,400 (Refer note 3)], as an adjustment to the ROU Asset.

Lease Liability	Dr.	₹ 4,900	
To ROU Asset			₹ 4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

ROU Asset	Dr.	1,31,200	
To Lease Liability			1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 7%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,070**	(1,15,690)	2,31,380
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,380	(1,15,690)	1,15,690
8	1,40,133	9,867*	(1,50,000)	-	1,15,690	(1,15,690)	-

*Difference is due to approximation

**Refer Note 5

Working Notes:

1. Calculation of lease liability on increased consideration:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	40,800
Modified lease liability			1,31,200

2. Calculation of remaining lease liability for the original contract of 2,000 square meters at original discount rate:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
Remaining lease liability			2,67,300

3. Calculation of remaining lease liability for the original contract of 2,000 square meters at revised discount rate:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	81,600
Remaining lease liability			2,62,400

4. Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200

5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	55,800
Lease liability as at modification date			7,35,900

5. Calculation of opening balance of Modified ROU Asset at the beginning of 6th year:

The remaining ROU Asset for the original 2,000 square metres of office space after decrease in term	2,20,770
Less: Adjustment for increase in interest rate from 6% to 7%	(4,900)
Add: Adjustment for increase in leased space	1,31,200
	3,47,070

Multiple Component Contract

Question 11

A lessee enters into a lease of an equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	₹ 80,000
Maintenance	₹ 10,000
Total	₹ 90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:

Lease	₹ 85,000
Maintenance	₹ 15,000
Total	₹ 1,00,000

In the given scenario, assuming lessee has not opted the practical expedient, how will the lessee allocate the consideration to lease and non-lease component?

Answer

The stand-alone price for the lease component represents 85% (i.e., ₹ 85,000/₹ 1,00,000) of total estimated stand-alone prices. The lessee allocates the consideration in contract (₹ 90,000), as follows:

Lease (₹ 90,000 x 85%)	₹ 76,500
Maintenance (₹ 90,000 x 15%)	₹ 13,500
Total	₹ 90,000

Question 12

Entity X (lessee) 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 annual lease rent of ₹ 70,000 is payable at year end. 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 annual service charges amounting to ₹ 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 ₹ 1,20,000 per year and stand-alone price of the 'facilities agreement' is ₹ 80,000 per year. 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?

Answer

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 ₹ 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 Price (₹)	% of total Stand-alone Price	Allocation of consideration (₹)
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 and 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	0.909	92,718
Year 2	1,02,000	0.826	84,252
Year 3	1,02,000	0.751	76,602
Year 4	1,02,000	0.683	69,666
Year 5	1,02,000	0.621	63,342
Year 6	1,02,000	0.564	57,528
Year 7	1,02,000	0.513	52,326
Year 8	1,02,000	0.467	47,634
Year 9	1,02,000	0.424	43,248
Lease Liability at commencement date			5,87,316

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

Question 13

A consumer products entity, Entity A Limited (lessee) enters into a lease agreement with Entity B Limited (lessor) for a dedicated production line to manufacture one of its store brand household products for a period of three years. Entity A Limited has agreed to order a minimum 1,00,000 units per month and to make a payment to Entity B Limited as per the following agreed rates:

- (i) ₹ 240 per unit if the ordered quantity is between 1,00,000 to 1,20,000 units.
- (ii) ₹ 246 per unit if the ordered quantity is between 1,20,001 to 1,50,000 units.

As per the terms of the agreement, Entity A Limited has the exclusive right to use the production line. Entity B Limited cannot use the specified production line for any other customer. The type of household product is specified in the contract. Entity A Limited issues instructions to Entity B about the quantity and timing of products to be delivered. If the production line is not producing the household product for Entity A, it remains idle. Entity B Limited operates and maintains the production line on a daily basis. Entity A Limited has estimated that for manufacturing each unit, Entity B Limited incurs an average cost of ₹ 195. Further, the observable stand-alone price for the rent of the production line is ₹ 60,00,000 per month. Entity A Limited's incremental borrowing rate at the commencement date of the lease is 10% per annum.

Entity A Limited concludes that the arrangement contains a lease as per Ind AS 116. It also elects not to apply practical expedient in paragraph 15 of Ind AS 116 of not to separate the non-lease component(s) from the lease component(s). Accordingly, it separates non-lease components from lease components.

You are required to:

- (i) Analyse the above and identify lease component(s) and non-lease component(s).

And at the commencement of the lease:

- (ii) Compute and allocate the consideration into lease component(s) & non-lease component(s).
- (iii) Compute the lease liability (PVAF @ 10% per annum is 2.49 for 3 years may be adopted).
- (iv) Determine the recognition/treatment of lease component(s) and non-lease component(s).

Answer

(i) and (ii) Identification of lease and non-lease components and allocation of consideration into these components

In the given case, the agreement contains a lease component (production line) and a non-lease component (job work). As Entity A has not elected to apply the practical expedient as provided in paragraph 15 of Ind AS 116, it will separate the lease and non-lease components and allocate the total consideration to the lease and non-lease components in the ratio of their relative stand-alone selling prices.

As Entity A is required to purchase a minimum of 1,00,000 units per month at the rate of ₹ 240 per unit, there is in substance **fixed payment of ₹ 2,40,00,000 per month** - although the payments are structured as variable lease payments, there is no genuine variability in those payments as Entity A is required to purchase a minimum quantity 1,00,000 units per month, i.e., for ₹ 2,40,00,000 per month.

The observable stand-alone price for lease component (which is factory rent) is ₹ 60,00,000. The observable stand-alone price of non-lease component (which is job work charges) is ₹ 1,95,00,000 (₹ 195 × 1,00,000 units).

Entity A is required to allocate the total consideration per month as follows:

Observable standalone price: Lease component	₹ 60,00,000
Observable standalone price: Non-lease component	₹ 1,95,00,000
Total	₹ 2,55,00,000
Lease component as % of observable prices [(₹ 60 lakh/₹ 255 lakh) x 100]	23.52941%
Allocation of consideration to lease component (₹ 2,40,00,000 x 23.52941%)	₹ 56,47,059
Non-lease component (₹ 2,40,00,000 - ₹ 56,47,059)	₹ 1,83,52,941

(iii) Computation of lease liability

The total allocation for a year will be ₹ 6,77,64,708 (₹ 56,47,059 x 12)

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

Lease Liability at commencement date = ₹ 6,77,64,708 x 2.49 = ₹ 16,87,34,123

(iv) Accounting treatment of lease components and non-lease components

- Entity A recognises lease liability amounting to ₹ 16,87,34,123 as at commencement date based on lease payments amounting to ₹ 56,47,059 per month.
- The remaining amount of ₹ 1,83,52,941 (₹ 2,40,00,000 - ₹ 56,47,059) is attributable to job work charges is recognised in the statement of profit and loss as and when incurred.

Question 14

Feel Fresh Limited (the Company) is into manufacturing and retailing of FMCG products listed on stock exchanges in India. One of its products is bathing soap which Company sells under brand name 'Feel Fresh'. The Company does not have its own manufacturing facilities for soap and therefore it enters into arrangements with a third party to procure soaps. The Company entered into a long-term purchase contract of 10 years with M/s. Radhey. Following are relevant terms of the contract with M/s. Radhey:

- M/s. Radhey has to purchase a machine costing ₹ 10,00,000 from the supplier as specified by the Company. The machine will be customized to produce the soaps as designed by the Company. This machine cannot be used by M/s. Radhey to produce the soaps for buyers other than the Company due to the design specifications. The machine has a useful life of 10 years and the straight line method of depreciation is best suited considering the use of the machine.
- The Company will pay ₹ 4.75 per soap for the first year of contract. This is calculated based on the budgeted annual purchase of 7,00,000 soaps as follows:

Particulars	Per soap price (₹)
Variable cost of manufacturing	4.00
Cost of machine (₹ 1,74,015/7,00,000 soaps)	0.25
M/s. Radhey's margin	0.50
Per soap cost to the Company	4.75

In case the Company purchases more than 7,00,000 (i.e. budgeted number of soaps) soaps in the first year then the cost of the machine (i.e. ₹ 0.25 per soap) will not be paid for soaps procured in excess of 7,00,000 units. However, in case Company procures less than budgeted number of soaps, then the Company will pay the differential unabsorbed cost of the machine, at the end of

the year. For example, if the Company purchases only 6,00,000 soaps in first year then the differential amount of ₹ 24,015 [$₹ 1,74,015 - (6,00,000 \times ₹ 0.25)$] will be paid by the Company to M/s. Radhey at the end of the year. Variable cost will be actualized at the end of the year.

- (iii) The cost per soap will be calculated for each year in advance based on the budgeted number of soaps to be produced each year. An amount of ₹ 1,74,015 shall be considered each year for the cost of machine for year 1 to year 8 while calculating the cost per soap. Any differential under absorbed amount shall be paid by the Company to M/s. Radhey at the end of that year. A charge of ₹ 1,74,015 per annum for the machine is derived using borrowing cost of 8% p.a. For year 9 and year 10, only variable cost and margins will be paid.
- (iv) M/s. Radhey does not have any right to terminate the contract but the Company has the right to terminate the contract at the end of each year. However, if the Company terminates the contract, it has to compensate M/s. Radhey for any unabsorbed cost of Machine. For example, if Company terminates the contract at the end of second year then it has to pay ₹ 10,44,090 (i.e. $1,74,015 \text{ per year} \times 6 \text{ remaining years}$). If it terminates the contract after the 8th year then the Company does not have to pay the compensation since the cost of the machine would have been absorbed.
- (v) In the first year, the Company purchases 5,50,000 soaps at ₹ 4.75 per soap.

Analyze the contract of the Company with M/s. Radhey and provide necessary accounting entries for first year in accordance with Ind AS with working notes. Assume all cash flows occur at end of the year.

Note: PVAF @ 8% per annum for 8 years is 5.74663

Answer

Identification of the contract (by applying para 9 of Ind AS 116)

(a) Identified asset

Feel Fresh Ltd. (a customer company) enters into a long-term purchase contract with M/s Radhey (a manufacturer) to purchase a particular type and quality of soaps for 10 year period.

Since for the purpose of the contract M/s Radhey has to buy a customized machine as per the directions of Feel Fresh Ltd. and also the machine cannot be used for any other type of soap, the machine is an identified asset.

(b) Right to obtain substantially all of the economic benefits from use of the asset throughout the period of use

Since machine cannot be used for manufacture of soap for any other buyer, Feel Fresh Ltd. will obtain substantially all economic benefits from the use of the asset throughout the period of use.

(c) Right to direct the use

Feel Fresh Ltd. controls the use of machine and directs the terms and conditions of the contract with respect to recovery of fixed expenses related to machine.

Hence the contract **contains a lease**.

Lease term

The lease term shall be **10 years** assuming reasonable certainty. Though the lessee is not contractually bound till 10th year, i.e., the lessee can refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate.

Identification of lease payment

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an

underlying asset during the lease term, comprising the following:

- (a) fixed payments (including in-substance fixed payments), less any lease incentives
- (b) variable lease payments that depend on an index or a rate
- (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- (d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Here in-substance fixed payments in the given lease contract are ₹ 1,74,015 p.a. The present value of lease payment which would be recovered in 8 years @ 8% would be ₹ 10,00,000 (approx.)

Variable lease payments that do not depend on an index or rate and are not, in substance, fixed are not included as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

Hence, lease liability will be recognized by ₹ 10,00,000 in the books of Feel Fresh Ltd. Since there are no payments made to lessor before commencement date less lease incentives received from lessor or initial direct costs incurred by lessee or estimate of costs for restoration/dismantling of underlying asset, the right of use asset is equal to lease liability.

Journal Entries

On initial recognition

ROU Asset	Dr.	₹ 10,00,000	
To Lease Liability			₹ 10,00,000
(To initially recognise Lease Liability & corresponding ROU Asset)			

At the end of the first year

Interest Expense (₹ 10,00,000 x 8%)	Dr.	₹ 80,000	
To Lease Liability			₹ 80,000
(To record interest expense and accrete the lease liability using the effective interest method)			
Depreciation Expense (₹ 10,00,000 / 10 years)	Dr.	₹ 1,00,000	
To ROU Asset			₹ 1,00,000
(To record depreciation on ROU using SLM)			
Lease Liability	Dr.	₹ 1,74,015	
To Bank			₹ 1,74,015
(To record lease payment)			
Purchase (Cost of soap)	Dr.	₹ 24,75,000	
To Bank [5,50,000 x ₹ (4 + 0.5)]			₹ 24,75,000
(To record variable expenses paid as cost of the goods purchased)			

Accounting of Finance Lease in Lessor's Books

Question 15

A Dealer-Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised

in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year
- Lessor expects the residual value of equipment to be ₹ 50,000 at the end of the 10-year lease term
- Lessee provides a residual value guarantee that protects Lessor from the first ₹ 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., ₹ 50,000)
- The equipment has an estimated remaining economic life of 15 years, a carrying amount of ₹ 1,00,000 and a fair value of ₹ 1,11,000
- The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset
- The interest rate implicit in the lease is 10.078%

How should the Lessor account for the same in its books of accounts? Pass necessary journal entries for the 1st year.

Answer

Lessor shall classify the lease as a Finance Lease because the sum of the present value of lease payments amounts to substantially all of the fair value of the underlying asset.

At lease commencement, Lessor accounts for the finance lease, as follows:

Lease Receivable (Net investment in the lease)	Dr.	₹ 1,11,000 ^(a)	
Cost of goods sold	Dr.	₹ 92,340 ^(b)	
To Revenue			₹ 1,03,340 ^(c)
To Inventory			₹ 1,00,000 ^(d)

To record the net investment in the finance lease and derecognise the underlying asset.

(a) The net investment in the lease consists of:

- (1) the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) and
- (2) the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

- (b) Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.
- (c) Revenue equals present value of lease payments.
- (d) The carrying amount of the underlying asset.

At lease commencement, **Lessor recognises selling profit of ₹ 11,000** which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) i.e. which equals ₹ 92,340]

Year 1

Journal entry for a finance lease

Cash	Dr.	₹ 15,000 ^(e)	
To Lease Receivable (Net investment in the lease)			₹ 3,813 ^(f)
To Interest income			₹ 11,187 ^(g)

Note:

- (e) Receipt of annual lease payments at the end of the year.
- (f) Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187
- (g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:

The following table summarises the interest income from this lease and the related amortisation of the net investment over the lease term:

Year	Annual Rental Payment	Annual Interest Income ^(h)	Net investment at the end of the year
Initial net investment	-	-	1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282
5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000 ⁽ⁱ⁾

- (h) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (net investment) x 10.078%.
- (i) The estimated residual value of the equipment at the end of the lease term.

Working Notes:

1. Calculation of present value of lease payments:

Year	Lease Payment (A)	Present value factor @10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285
6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960

9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	11,480*
			1,03,340

*Figure has been rounded off for equalization of journal entry.

2. Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

Question 16

A company manufactures specialised machinery. The company offers customers the choice of either buying or leasing the machinery. A customer chooses to lease the machinery. Details of the arrangement are as follows:

- (i) The lease commences on 1st April, 20X1 and lasts for three years.
- (ii) The lessee is required to make three annual rentals payable in arrears of ₹ 57,500.
- (iii) The leased machinery is returned to the lessor at the end of the lease.
- (iv) The fair value of machinery is ₹ 1,50,000, which is equivalent to the selling price of machinery.
- (v) The machinery cost ₹ 1,00,000 to manufacture. The lessor incurred costs of ₹ 2,500 to negotiate and arrange the lease.
- (vi) The expected useful life of the machinery is 3 years. The machinery has an expected unguaranteed residual value of ₹ 10,000 at the end of year three. The estimated residual value does not change over the term of the lease.
- (vii) The interest rate implicit in the lease is 10.19%.

The lessor classifies the lease as a finance lease.

How should the Lessor account for the same in its books of accounts? Pass necessary journal entries.

Answer

The cost to the lessor for providing the machinery on lease consists of the book value of the machinery (₹ 1,00,000), plus the initial direct costs associated with entering into the lease (₹ 2,500), less the future income expected from disposing of machinery at the end of lease (the present value of unguaranteed residual value of ₹ 10,000 discounted @ 10.19%, being ₹ 7,470). This gives a cost of sale of ₹ 95,030.

The lessor records the following entries at the commencement of the lease:

		₹	₹
Lease receivable	Dr.	1,50,000	
Cost of sales	Dr.	95,030	
To Inventory			1,00,000
To Revenue			1,42,530
To Bank			2,500

The sales profit recognised by the lessor at the commencement of the lease is therefore ₹ 47,500 (₹ 1,42,530 – ₹ 95,030). This is equal to the fair value of the machinery of ₹ 1,50,000, less the book value of the machinery (₹ 1,00,000) and the initial direct costs of entering into the lease (₹ 2,500). Revenue is equal to the lease receivable (₹ 1,50,000), less the present value of the unguaranteed residual value (₹ 7,470).

Year	Lease receivable at beginning of year (₹) (a)	Lease payments (₹) (b)	Interest Income (10.19% p.a.) (₹) (c)	Decrease in lease receivable (₹) (d) = (b) - (c)	Lease receivable at end of year (₹) (e) = (a) - (d)
1	1,50,000	57,500	15,285	42,215	1,07,785
2	1,07,785	57,500	10,983	46,517	61,268
3	61,268	57,500	6,232*	51,268	10,000

*Difference is due to approximation

The lessor will record the following entries:

			₹	₹
Year 1	Bank Dr.		57,500	
	To Lease receivable			42,215
	To Interest income			15,285
Year 2	Bank Dr.		57,500	
	To Lease receivable			46,517
	To Interest income			10,983
Year 3	Bank Dr.		57,500	
	To Lease receivable			51,268
	To Interest income			6,232

At the end of the three-year lease term, the leased machinery will be returned to the lessor, who will record the following entry:

		₹	₹
Inventory Dr.		10,000	
To Lease receivable			10,000

Question 17

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 ₹ 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 ₹ 50,000 at the end of 3rd year.
- 3 equal annual installments are made at the end of each year.
- Implicit Interest Rate (IRR) = 10%.

- Present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is 0.7513.
- Present value of annuity of ₹ 1 due for 3 years at 10% is 2.4868.
- Assume that the fair value of the machine on lease is equivalent to the cost of the machine.

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

Answer

- (i) A lease is classified as a finance lease if it transfers substantially all 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.

Computation of annual lease payment to the lessor

	₹
Cost of equipment (Fair value)	8,00,000
Unguaranteed residual value	50,000
Present value of unguaranteed residual value @ 10% (₹ 50,000 × 0.7513)	37,565
Fair value to be recovered from lease payments (₹ 8,00,000 – ₹ 37,565)	7,62,435
Present value of annuity for three years is 2.4868	
Annual lease payment (₹ 7,62,435 / 2.4868)	3,06,593

The present value of lease payment i.e., ₹ 7,62,435 is more than 95% of the fair market value i.e., ₹ 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.

- (ii) **Computation of Unearned Finance Income**

	₹
Total lease payments (₹ 3,06,593 × 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

Accounting of Operating Lease in Lessor's Books

Question 18

How will Entity Y account for the incentive in the following scenarios. Pass necessary journal entries:

Scenario A

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of ₹ 1,10,000. In order to induce Entity X to enter into the lease, Entity Y provides ₹ 6,00,000 to Entity X at lease commencement for lessee improvements (i.e., lessee's assets).

Scenario B

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of ₹ 1,10,000. At lease commencement, Entity Y provides ₹ 6,00,000 to Entity X for leasehold improvements which will be owned by Entity Y (i.e., lessor's assets). The estimated useful life of leasehold improvements is 5 years.

Answer

Para 70 of Ind AS 116 state that at the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:

- (a) fixed payments (including in-substance fixed payments as described in para B42), less any lease incentives payable;
- (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- (c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in para B37); and
- (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Further para 71 of the standard states that a lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished."

Scenario A

In accordance with above, at lease commencement, Entity Y accounts for the incentive as follows:

To account for the lease incentive

Deferred lease incentive	Dr.	₹ 6,00,000	
To Bank			₹ 6,00,000

Recurring monthly journal entries in Years 1-5

To record cash received on account of lease rental and amortisation of lease incentive over lease term

Bank	Dr.	₹ 1,10,000	
To Lease income			₹ 1,00,000
To Deferred lease incentive [₹ 6,00,000 ÷ 60 months]			₹ 10,000*

Scenario B

Entity Y provided lease incentive amounting to ₹ 6,00,000 to Entity X for leasehold improvements in the premises. As Entity Y has the ownership of leasehold improvements carried out by lessee, it shall account for same as property, plant and equipment & shall depreciate the same over its useful life.

In accordance with above, in the given case, at lease commencement, Entity Y accounts for the incentive as follows:

To record the lease incentive

Property, plant & Equipment	Dr.	₹ 6,00,000	
To Bank			₹ 6,00,000

Recurring monthly journal entries in Years 1-5

To record cash received on account of lease rental over the lease term

Bank	Dr.	₹ 1,10,000	
To Lease income			₹ 1,10,000

To record depreciation on PPE over the lease term using straight line method

Depreciation	Dr.	₹ 10,000	
To PPE			₹ 10,000

Accounting of Sale and Lease Back**Question 19**

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of ₹ 30,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 15,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with 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 Ind AS 115 'Revenue from Contracts with Customers'.

The fair value of the building at the date of sale is ₹ 27,00,000. 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.

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

How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor? Pass necessary journal entry for the same.

Note: PVAF @ 12% for 20 years is 7.47

Answer

Considering facts of the case, Seller-lessee and 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 ₹ 3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price	30,00,000
Less: Fair Value (at the date of sale)	(27,00,000)
Additional financing provided by Buyer-lessor to Seller-lessee	3,00,000

Next step would be to calculate the present value of the annual payments which amounts to ₹ 14,94,000 (calculated considering 20 payments of ₹ 2,00,000 each, discounted at 12% p.a.) of which ₹ 3,00,000 relates to the additional financing (as calculated above) and balance ₹ 11,94,000 relates to the lease.

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)	15,00,000
Fair Value (at the date of sale)	(B)	27,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
ROU Asset	[(A/B) x C]	6,63,333

Seller-lessee recognises 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)	27,00,000
Carrying Amount	(B)	15,00,000
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]	5,30,667
Relating to the rights transferred to Buyer-lessor	(D - E)	6,69,333

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

Bank	Dr.	30,00,000	
ROU Asset	Dr.	6,63,333	
To Building			15,00,000
To Financial Liability (Lease liability + Loan liability)			14,94,000
To Gain on rights transferred			6,69,333

Buyer-Lessor:

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	Dr.	27,00,000	
Loan (Financial Asset)	Dr.	3,00,000	
To Bank			30,00,000

Section B – Fully Irrelevant Theoretical Questions

Question 1

Scenario A

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

Analyze whether the lessee can take a short-term exemption in accordance with Ind AS 116.

Scenario B

Assume same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

Advise will your answer be different in this case.

Answer

Scenario A

As the lessee is reasonably certain to exercise the extension option, the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

Scenario B

In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis.

Question 2

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but, Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Comment whether there is an identified asset.

Answer

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

Question 3

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

State whether there is an identified asset.

Answer

Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is implicitly specified at the time the same will be made available to Customer XYZ.

Question 4**Scenario A**

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Scenario B

Assume the same facts as in Scenario A except that Server No. 10 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Answer**Scenario A**

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (for e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B

The substitution right is not substantive, and Server No. 10 would be an identified asset because the

supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

Question 5

A lessee enters into a ten-year contract with a lessor (freight carrier) to transport a specified quantity of goods. Lessor uses rail wagons of a particular specification, and has a large pool of similar rail wagons that can be used to fulfil the requirements of the contract. The rail wagons and engines are stored at lessor's premises when they are not being used to transport goods. Costs associated with substituting the rail wagons are minimal for lessor.

Whether the lessor has substantive substitutions rights and whether the arrangement contains a lease?

Answer

In this case, the rail wagons are stored at lessor's premises and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same become economically beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive and the arrangement does not contain a lease.

Question 6**(SM)**

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Examine whether there is an identified asset.

Answer

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract.

Question 7**(SM)****Scenario A**

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Examine whether there is an identified asset.

Scenario B

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Assess whether there is an identified asset.

Answer

Scenario A

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer XYZ with the right to obtain substantially all of the economic benefits from use of pipeline.

Scenario B

No, the capacity portion of the pipeline is NOT an identified asset.

Since 65% of the pipeline's capacity is less than substantially all of the capacity of pipeline, Customer XYZ does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Question 8

(SM)

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Recommend which party has the right to control the use of the identified asset during the period of use.

Answer

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

Question 9

(SM)

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.

Examine who has the right to substantial benefits from the solar farm.

Answer

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar

farm over the 15-year period because it obtains:

- the electricity produced by the farm over the lease term – i.e. the primary product from use of the asset; and
- the renewable energy credits – i.e. the by-product from use of the asset.

Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

Question 10**(SM)**

Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M's energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced. Whether it can be established that M is having the right to control the use of identified asset?

Answer

In this case, the nature of the solar plant is such that all of the decisions about how and for what purpose the asset is used are predetermined because:

- the type of output (i.e. energy) and the production location are predetermined in the agreement; and
- when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how and for what purpose the solar plant is used. Hence, M is having right to control use of asset.

Question 11**(SM)**

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down). Under the contract:

- Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).
- Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.

State whether Customer X has the right to direct the use of the vehicle throughout the period of lease.

Answer

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

Question 12**(SM)**

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Examine which party has right to control use of the identified asset (i.e., equipment) during the period of use.

Answer

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

Question 13**(SM)**

Entity L enters into a five-year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship, and is responsible for safe passage.

State who has the right to direct the use of the ship during the period of use.

Answer

Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

Question 14**(SM)**

A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. Customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship, and is responsible for safe passage.

Does the customer have the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

Answer

The customer has the right to direct the use of the ship because the contractual restrictions are merely protective rights that protect the company's investment in the ship and its personnel. In the scope of its right of use, the customer determines how and for what purpose the ship is used throughout ten-year period because it decides whether, where and when ship sails, as well as cargo that it will transport.

The customer has the right to change these decisions throughout the period of use and hence, the contract contains a lease.

Question 15**(SM)****Case I**

Scenario 1: The 'last mile' is a dedicated cable that connects Entity Y's network with the end customer's device. The use of this cable is at the discretion of the customer. Entity Y decides the location of end points and has right to replace the lines (dedicated cable), however it is not practical to replace the lines, since replacement would require additional costs to be incurred without any corresponding benefit. Whether the arrangement would be within the scope of Ind AS 116?

Scenario 2: If it is practical for the Entity Y to replace the lines and Entity Y would benefit from this replacement, would the answer be different?

Case II

Customer X enters into a 10-year contract with a utility company, Entity Y, for the right to use three specified, physically distinct fibers within a larger cable connecting Mumbai to Delhi. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment. Entity Y owns extra fibers but can substitute those for Customer's fibers only for reasons of repairs, maintenance or malfunction. The useful life of the fiber is 15 years. Whether this arrangement is covered under Ind AS 116?

Case III

Customer X enters into a 10-year contract with Entity Y for the right to use a specified amount of capacity within a cable connecting Mumbai to Delhi. The specified amount is equivalent to Customer X having the use of the full capacity of three fiber strands within the cable (the cable contains multiple fibers with similar capacities). Entity Y makes decisions about the transmission of data (i.e., Entity Y lights the fibers, makes decisions about which fibers are used to transmit Customer's traffic). The useful life of the fiber is 15 years. Whether this arrangement is covered under Ind AS 116?

Answer

Paragraph 9, B9, B13 and B14 of Ind AS 116 state the following:

“9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.”

“B9 To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset; and
- (b) the right to direct the use of the identified asset.”

“B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at time that asset is made available for use by customer.”

“B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:

- (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
- (b) the supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).”

Paragraph B20 of Ind AS 116 which provides guidance regarding identified asset in case of portion of assets states that a capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Paragraph B21 of Ind AS 116, inter alia, states that to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or subleasing the asset.

Further, paragraph B24 of Ind AS 116 provides that a customer has the right to direct the use of an identified asset throughout the period of use if the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

Paragraph B25 of Ind AS 116 states that a customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

Case I**Scenario 1:**

- (i) As per paragraph B13 of Ind AS 116, 'Last mile' which is a dedicated cable is an identified asset since it is physically distinct.
- (ii) There are no substantive substitution rights with Entity Y, as it does not have the practical ability to substitute alternative assets throughout the period of use.

Thus, this arrangement is within the scope of Ind AS 116.

Scenario 2:

If Entity Y has the practical ability to replace the lines and it would benefit from such replacement, Entity Y has substantive substitution rights. In such case, this arrangement for the 'last mile cable' will not be within the scope of Ind AS 116.

Case II

The fibers are specified in the contract and are physically distinct. Hence, in accordance with paragraph B13 and B20, the said three fibers are identified asset.

Paragraph B18, inter alia, states that the supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset.

Further, paragraph B27 provides that although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and can actually be dependent on the decisions about how and for what purpose the asset is used.

In accordance with the above, as Entity Y can substitute these three distinct fibers only for reasons of repairs, maintenance or malfunction, it does not preclude them from being an identified asset.

Further, the Customer X has right to control the use of the identified fibers for 10 year since it has –

- (a) the right to obtain substantially all of the economic benefits from use of the identified fibers throughout the period of use, i.e., 10 years; and
- (b) the right to direct the use of the fibers as it makes the decisions about the use of the fibers, i.e., it has right to direct how and for what purpose the fibers are used throughout the period of use.

Hence, this arrangement is within the scope of Ind AS 116.

Case III

Paragraph B20 specifically provides that a capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. In the given case, the capacity portion that will be provided to Customer X is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable, thus, it is not an identified asset. Further, Entity Y makes all decisions about the transmission of data, (i.e., supplier lights the fibers, makes decisions about which fibers are used to transmit customer's traffic).

Thus, the contract does not contain a lease and is therefore not within the scope of Ind AS 116.

Question 16

(SM)

Scenario A

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are termination penalties or other factors indicating that Entity ABC is not reasonably certain to exercise the renewal option.

Explain the lease term.

Scenario B

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property.

Explain the lease term.

Scenario C

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years.

Explain the lease term.

Answer**Scenario A**

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since it is mentioned that Entity ABC is not reasonably certain to exercise the option because there are no penalties or other factors which indicate that the entity will opt for renewal of lease.

Scenario B

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

Scenario C

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

Question 17

(SM)

A Lessee enters into a non-cancellable lease contract with a Lessor to lease a building. Initially, the lease is for five years, and lessee has the option to extend the lease by another five years at the same rental.

To determine the lease term, the lessee considers the following factors:

- Market rentals for a comparable building in the same area are expected to increase by 10% over the ten-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
- The lessee intends to stay in business in the same area for at least 20 years.
- The location of the building is ideal for relationships with suppliers and customers.

What should be the lease term for lease accounting under Ind AS 116?

Answer

After considering all the stated factors, the lessee concludes that it has a significant economic incentive to extend the lease.

Thus, for the purpose of lease accounting under Ind AS 116, the lessee uses a lease term of ten years.

Question 18

(SM)

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased.

Analyze whether Retailer M required to reassess the lease term in this case.

Answer

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew/extend the lease. In the given case, the Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess lease term at end of third year.

Question 19

(SM)

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N has determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country.

Examine will the lease term be reassessed in this case.

Answer

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the

underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

Question 20**(SM)****Scenario A**

A lessee enters a lease of an excavator and the related accessories (for e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.

State how many lease and non-lease components are there.

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (for e.g., to transport iron ores at another mine).

Answer**Scenario A**

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz., a lease of the excavator (together with the accessories) and a lease of the loading truck.

Question 21**(SM)**

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes single monthly rental payment and does not pay for maintenance separately. The office building has useful life of 40 years and HVAC system and office furniture each has a life of 15 years.

State what are the units of account in the lease.

Answer

There are three components in the arrangement - the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated

into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use.

The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

Question 22**(SM)****Scenario A**

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹ 10,000. The contract contains fixed annual payments as follows: ₹ 8,000 for rent, ₹ 1,500 for maintenance and ₹ 500 of administrative tasks.

Explain how the consideration would be allocated.

Scenario B

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

Explain how the consideration would be allocated.

Answer**Scenario A**

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Question 23**(SM)**

A Lessee enters into a ten-year lease contract with a Lessor to use equipment. The contract includes maintenance services (as provided by lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 relate to maintenance services and ₹ 500 to insurance costs).

The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for similar equipment because none is leased without related maintenance services provided by the lessor.

How would the Lessee allocate the consideration to the lease component?

Answer

The observable stand-alone price for maintenance services is ₹ 2,000. There is no observable stand-alone price for the lease. Further, the insurance cost does not transfer a good or service to the lessee and therefore, it is not a separate lease component.

Thus, the Lessee allocates ₹ 8,000 (₹ 10,000 – ₹ 2,000) to the lease component.

Question 24**(SM)**

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 2,00,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 1,70,000 for rent and ₹ 30,000 for real estate taxes.

State the fixed lease payments for the purpose of classifying the lease.

Answer

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

Question 25**(SM)**

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

- If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.
- If Q does not use machinery within a given month, then an amount of 1,000 accrues for that month.

Explain what is considered as lease payment in this case.

Answer

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

Question 26**(SM)**

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental

rate on each anniversary of the lease commencement date.

Describe the lease payments for the purpose of measuring lease liability.

Answer

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

Question 27

(SM)

Company N leases a production line. The lease payments depends on the number of operating hours of the production line, i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours.

Determine the lease payment.

Answer

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

Question 28

(SM)

A Company leases a manufacturing facility. The lease payments depend on the number of operating hours of the manufacturing facility, i.e., the lessee has to pay ₹ 2,000 per hour of use. The annual minimum payment is ₹ 2,00,00,000. The expected usage per year is 20,000 hours.

Whether the said payments be included in the calculation of lease liability under Ind AS 116?

Answer

The said lease contains in-substance fixed payments of ₹ 2,00,00,000 per year, which are included in the initial measurement of the lease liability under Ind AS 116.

However, the additional ₹ 2,00,00,000 that the company expects to pay per year are variable payments that do not depend on an index or rate and, thus, are not included in the initial measurement of the lease liability but, are expensed when the over-use occurs.

Question 29

(SM)

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Determine the lease payments.

Answer

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000/100 x 108).

Question 30

(SM)

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analyze whether these payments affect the calculation of lease liability and ROU Asset. Further discuss how Entity XYZ and Customer ABC would allocate these lease payments.

Answer

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract (assuming Customer ABC does not elect to combine lease and non-lease components for this class of asset).

If Customer ABC elects the practical expedient not to separate the associated non-lease component from the lease component and instead accounts for the lease component and the non-lease component as a single lease component, the future payments for the consumables will still constitute genuine variability. Hence there will also be no lease payments for purposes of initial measurement.

Question 31

(SM)

Entity A enters into a five-year lease of an office building. The lease payments are ₹ 5,00,000 per year and the contract includes an additional water charge calculated as ₹ 0.50 per litre consumed. Payments are due at the end of year. Entity A elects to apply the practical expedient to combine lease and non-lease components.

Answer

As stated above, payments are due at the end of the year. Entity A elects to apply the practical expedient not to separate lease and non-lease components.

At the commencement date, Entity A measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of 5,00,000). Although Entity A has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, Entity A excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because Entity A has elected not to separate them from the fixed lease payments. Entity A recognises the payments for water - as a variable lease payment - in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water - as an operating expense - in profit or loss when they are incurred.

Question 32**(SM)**

An entity (a lessee) enters into a lease and guarantees that the lessor will realise ₹ 20,000 from selling the asset to another party at the end of the lease. At lease commencement, based on the lessee's estimate of the residual value of the underlying asset, the lessee determines that it expects that it will owe ₹ 8,000 at the end of the lease. Whether the lessee should include the said payment of ₹ 8,000 as a lease payment?

Answer

The lessee should include the amount of ₹ 8,000 as a lease payment because it is expected that it will owe the same to the lessor under the residual value guarantee.

Question 33**(SM)**

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 1,00,000 flight hours. At the end of the lease, company H must have a check performed (or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Answer

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at end of lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

Question 34**(SM)**

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6,

Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

Answer

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

Question 35

(SM)

Entity ABC (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 40 years. Entity ABC subleases the building for four years.

How should the said sublease be classified by Entity ABC?

Answer

The sublease is classified with reference to the 'ROU Asset' in the head lease (and NOT the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (NOT compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

Question 36

(SM)

Head lease

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease

At the beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e. three years of the head lease to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Answer

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies sublease as finance lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease).

When the intermediate lessor enters into a sublease, the intermediate lessor:

- (i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;
- (ii) recognises any difference between ROU asset and net investment in sublease in profit or loss; &
- (iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both

- finance income on the sublease AND
- interest expense on the head lease.

Question 37

(SM)

Head lease

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease

At the commencement of the head lease, the intermediate lessor subleases the 10,000 square metres of office space for two years to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Answer

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the two-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as an operating lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease and since, it is not satisfied, classified the same as an operating lease).

When the intermediate lessor enters into the sublease, the intermediate lessor retains:

- the lease liability AND
- the ROU asset

both relating to the head lease in its balance sheet.

During the term of the sublease, the intermediate lessor:

- (a) recognises a depreciation charge for the ROU asset and interest on the lease liability; AND
- (b) recognises lease income from the sublease.

Sub-lessee Accounting:

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Ind AS 116's recognition and measurement provisions).

Question 38

A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

To determine the lease term, the lessee considers the following factors:

- The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.
- The cost to install the machine in lessee's manufacturing facility is significant.
- The non-cancellable term of lessee's manufacturing facility lease ends in 15 years, and the lessee has an option to renew that lease for another twelve years.
- Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
- The total remaining life of the machine is 30 years.

What should be the lease term for lease accounting under Ind AS 116?

Answer

The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

Thus, the lessee concludes that the lease term consists of the 15-year non-cancellable period only.

Question 39

Entity X, a utility company enters into a contract for twenty years with Entity Y, a power company, to purchase all of the electricity produced by a new solar power station. The solar power station is explicitly specified in the contract and Entity Y has no substitution rights. Entity Y owns the solar power station and will receive tax credits relating to the construction and ownership of the solar power station, and Entity X will receive renewable energy credits that accrue from use of the solar power station.

Whether Entity X has the right to obtain substantially all of the economic benefits from the solar power station during the period of arrangement?

Answer

Paragraphs B21 of Ind AS 116 states that to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with third party.

In the given case, Entity X has the right to obtain substantially all of the economic benefits from the use of the solar power station over the 20-year period because it obtains:

- electricity produced by the power station i.e. the primary product from use of the asset over the lease term and
- renewable energy credits - i.e. the by-product from use of the asset.

Although Entity Y will receive economic benefits from the solar power station in the form of tax credits, those economic benefits relate to the ownership of the solar power station rather than the use of the power station. Thus, these credits are not considered in this assessment.

Question 40 [Transition to Ind AS 116 is Not Relevant at Present]

A retailer (lessee) entered into 3-year lease of retail space beginning at 1st April 2017 with three annual lease payments of ₹ 2,00,000 due on 31st March 2018, 2019 and 2020, respectively. The lease is classified as an operating lease under Ind AS 17. The retailer initially applies Ind AS 116 for the first time in the annual period beginning at 1st April 2019. The incremental borrowing rate at the date of initial application (i.e., 1st April 2019) is 10% p.a. and at the commencement of the lease (i.e., 1st April 2017) 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 using all the following transition approaches:

- Full Retrospective Approach
- Modified Retrospective Approach
 - Alternative 1
 - Alternative 2

Show the impact of adjustments through journal entries.

Answer

(i) 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, 2017 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 st Mar 2018	2,00,000	0.8929	1,78,580
31 st Mar 2019	2,00,000	0.7972	1,59,440
31 st Mar 2020	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 st Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 st Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 st Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 st Mar 2018	4,80,380	(1,60,126)	3,20,254
31 st Mar 2019	3,20,254	(1,60,127)	1,60,127
31 st Mar 2020	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 st Apr 2017	4,80,380	4,80,380	-	-	-
31 st Mar 2018	3,20,254	3,38,026	-	-	-
1 st Apr 2018	3,20,254	3,38,026	-	-	(17,772)
31 st Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
1 st Apr 2019	1,60,127	1,78,589	-	-	-
31 st Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-2020 is the first year of adoption and using Full retrospective method the comparative for 2018-2019 needs to be restated and 1st April 2018 (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 2018 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 2018 (assuming that only the 2018-2019 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 st April 2018)			

The following journal entries would be recorded during 2018-2019:

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 2019-2020:

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)			

(ii) Modified Retrospective Approach (Alternative 1):

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, 2019 to 31st March, 2020 in this case) discounted using the incremental borrowing rate as of the date of initial application being 1st April, 2019 (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 2017 in this case) by using incremental borrowing rate as at transition date.

Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @ 10%	Discounted Cash Flows/Present Value
31 st Mar 2020	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 st Mar 2020	1,81,820	18,180*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening Balance	Depreciation	Closing Balance
31 st Mar 2020	1,65,787***	(1,65,787)	-

*** (Refer note no 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
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1 st Apr 2017	4,97,360*	4,97,360**	-	-	-
31 st Mar 2018	3,31,574	3,47,096	49,736	1,65,786	-
31 st Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
1 st Apr 2019	1,65,787	1,81,806	-	-	-
31 st Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

** (Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at 1st April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as 1st April 2019.

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 1 st April 2019)			

The following journal entries would be recorded during 2019-2020:

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)			

Note:

1. Calculation of Present value of lease payments as at commencement date i.e., 1st April, 2017

Year	Payments (Cash flows)	Discounting Factor @ 10%	Discounted Cash Flows/Present Value
31 st Mar 2018	2,00,000	0.9091	1,81,820
31 st Mar 2019	2,00,000	0.8264	1,65,280
31 st Mar 2020	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 st Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 st Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806

31 st Mar 2020	1,81,806	18,194*	(2,00,000)	-
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*Difference is due to approximation

3. Calculation of ROU asset as at transition date i.e., 1st April, 2019

Year	Opening	Depreciation	Closing
31 st Mar 2018	4,97,360	(1,65,786)	3,31,574
31 st Mar 2019	3,31,574	(1,65,787)	1,65,787
31 st Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of initial application to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial application being 1st April 2019 (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date.

Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @ 10%	Discounted Cash Flows/Present Value
31 st Mar 2020	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 st Mar 2020	1,81,820	18,180*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening Balance	Depreciation	Closing Balance
31 st Mar 2020	1,81,820	(1,81,820)	-

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 st Apr 2019	1,81,820	1,81,820	-	-	-
31 st Mar 2020	-	-	18,180	1,81,820	-

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1st April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset	Dr.	₹ 1,81,820	
To Lease Liability			₹ 1,81,820
(To initially recognise the lease-related asset and liability as of 1 st April 2019)			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	₹ 18,180	
To Lease Liability			₹ 18,180
(To record interest expense and accrete the lease liability using the interest method)			
Depreciation expense	Dr.	₹ 1,81,820	
To ROU Asset			₹ 1,81,820
(To record depreciation expense on the ROU asset)			
Lease Liability	Dr.	₹ 2,00,000	
To Cash			₹ 2,00,000
(To record lease payment)			

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	Full Retrospective Approach	Modified Retrospective Approach (Alternative 1)	Modified Retrospective Approach (Alternative 2)
Opening balance sheet impact as on 1st April 2019:			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
Period ended 31st March 2020 activity:			
Cash lease payments	2,00,000	2,00,000	2,00,000
Lease payments recognised:			
Interest expense	21,411	18,194	18,180
Depreciation expense	1,60,127	1,65,787	1,81,820
Total periodic expense	1,81,538	1,83,981	2,00,000