

Decoding the new lease accounting standard

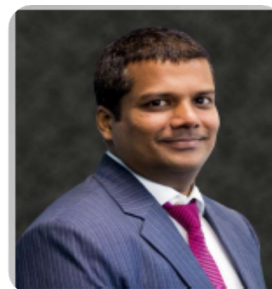
We hosted a conference call with Mr Sandip Khetan, Partner and National Leader of Financial Accounting Advisory Services (FAAS), EY India to decode the new lease accounting standard – Ind-AS 116. Mr Khetan believes that the impact from the new standard will be fairly broad and significant. His analysis on the BSE-100 companies suggests that the potential impact on the balance sheet, excluding banks, will be to the tune of ~INR1.4t. This new change will bring in consistency between companies that have different finance strategies and asset models (such as high lease asset v/s owned asset).

Key Highlights:

- Ind-AS 116 – which has become effective from 1st Apr'19 – will bring in a significant change in the financial statements of all companies. The standard will primarily impact the lessee, while lessor accounting will remain largely unchanged, except for the need to comply with the additional disclosure requirement.
- The new standard is doing away with the distinction between operating lease and finance lease. Thus, all leases will have to be recorded on the balance sheet.
- It requires companies to capitalize long-term liability toward operating lease payment (currently off balance sheet) in the balance sheet with a corresponding intangible asset in the form of right to use asset.
- This will eliminate income statement distortion between companies that used to own asset by financing it from banks and companies that used to lease assets to keep themselves asset-light.
- Operating lease expense shall no longer be charged to the income statement, and thus, EBITDA of all companies shall increase throughout the lease tenure.
- Depreciation on right to use asset and interest on lease liability shall now be charged in the income statement. On the other hand, (a) depreciation shall be charged using the straight line method over the life of the asset and (b) interest expense due to the unwinding of lease liability shall be higher in the initial period of the lease.
- Therefore, the impact on PAT shall be adverse in the initial phase of the lease due to front-loading of interest expense. It will be followed by a positive impact in the latter half of the lease. Overall impact on the income statement over the life of the lease term shall remain unchanged.
- Operating cash flow may improve, while correspondingly investing/financial cash flows may be impacted. Also, as this is an accounting change, the overall impact on cash flow shall remain neutral.

Other highlights:

- **Lease rental commitment denominated in foreign currency** is monetary liability and companies are required to fair value this lease liability at each reporting date. Any mark-to-market income/loss due to foreign currency fluctuations shall be routed through the income statement, which may heighten volatility. The extent of volatility shall depend upon the quantum of lease liability denominated in foreign currency.



**Mr Sandip Khetan —
Partner & National Leader,
FAAS, EY India**

Mr Sandip is a Chartered Accountant with over 20 years' experience. He is a subject matter expert in Indian GAAP, IND AS, IFRS and US GAAP. Sandip has extensive experience in providing various assurance and advisory related services to clients across multiple industry segments like manufacturing, power, financial services, e-commerce, infrastructure and software. He is a special invitee to the Ind-AS implementation group of Institute of Chartered Accountants of India.

Over the years, Sandip has been a trusted advisor to clients and has served as engagement partner for multiple client initiatives.

- **Additional direct charges such as maintenance expense** in lease agreement can be capitalized based on the accounting choice provided under the new lease accounting standard. Accordingly, maintenance cost can be amortized in the income statement, unlike as recorded up-front under the erstwhile accounting standard.
- **Control of renewal option** would decide the tenure of the capitalized operating lease. Following are possible scenarios:
 - If the lessee controls the renewal option, then the lessee shall determine the lease term based on management prudent judgment about whether or not the renewal option shall be exercised.
 - If the lessor controls the renewal option, then the lessee has to capitalize the lease rental over the entire life of the lease term, including the renewable term.
 - If renewal option is based on mutual agreement, then (a) for the initial period of the lease term, the lessee should capitalize, as it does not have the option to renew or avoid the renewal and (b) for the remaining lease term, capitalization would depend on the exercise of the renewal option.
- **Embedded lease** is structured as a service arrangement, but in substance it has underlying tangible asset for fulfillment of service obligation. Companies have the option to (a) split accounting and capitalize qualifying lease rental or (b) capitalize the entire embedded lease, including service arrangements.
- **Transitional approach** can materially change the impact of the standard. Following are the three transitional approaches:
 - **Prospective approach:** Lease asset and lease liability shall be recognized based on the remaining lease term at the time of transition. The impact on income statement shall be adverse in the initial year, followed by a positive impact in the subsequent year. On the other hand, net equity shall remain unaffected on the date of transition.
 - **Full retrospective approach and Modified retrospective approach:** Depreciation and interest shall be recomputed from the date of initial origination of lease till the transition date to arrive at right to use asset and lease liability. Key difference between these two methods is the incremental borrowing rate used. Under the full retrospective approach, **the borrowing rate as on the lease origination date** is used for capitalization. Separately, under the modified retrospective approach, **the borrowing rate as on the transition date** is used for capitalization. Difference between right to use asset and lease liability on the date of transition shall be charged to networth. These methods (full retrospective and modified retrospective) are likely to have a positive impact on the income statement.

Please refer our detailed [note](#) on 'Lease accounting' which highlights the possible impact on the financial statements of companies.

NOTES

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