Key highlights

- The new standard will require lessees to recognize most leases on their balance sheets. Lessees will use a single accounting model for all leases, with limited exemptions.
- For aircraft and other assets taken on an operating lease, the airline company will recognize right-to-use asset together with a lease liability on the balance sheet.
- Foreign currency leases will increase P&L volatility due to a restatement of foreign currency liability.
- Significant KPIs such as debt-equity ratio, EBITDA and return on capital employed (ROCE) will be affected.
- Lessor accounting is substantially unchanged.
- Ind AS 116 is likely to be effective for accounting periods beginning on or after 1 April 2019.

The International Accounting Standards Board (IASB) issued IFRS 16 Leases, which requires lessees to recognize assets and liabilities for most leases. For lessors, there is little change to the existing accounting in IAS 17 Leases. IFRS 16 will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 Revenue from Contracts with Customers, has been applied or is applied at the same date as IFRS 16.

Based on the IFRS Convergence Status - 8 February 2018 hosted on the ICAI website1, Ind AS 116 (corresponding to IFRS 16) is under consideration of the National Advisory Committee on Accounting Standards (NACAS). Ind AS 116 is likely to be effective for accounting periods beginning on or after from 1 April 2019. However, the option of early application of Ind AS 116 from 1 April 2018 is proposed.

Key considerations

Determining whether an arrangement contains a lease

Under the new standard, a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset, which could be a physically distinct portion of an asset such as a floor of a building.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to: (1) obtain substantially all of the economic benefits from the use of the identified asset and (2) direct the use of the identified asset (i.e., direct how and for what purpose the asset is used).

Example

An airline company enters into a contract with an airport operator for using space in the city airport. The airline company will use this space to deploy its check-in machines and other equipment. As per the contract, the airline operator will provide a particular area of space and the space must be located within the entrance hall. However, the operator has a right to change the allocated location at any time during the contract. The entrance hall of the airport has several unoccupied places that will meet the airline company’s requirements. The airport operator needs to incur minimal costs for changing the allocated space. The airport operator will economically benefit by changing the space allocated to a customer.

Evaluation

The arrangement does not contain a lease. While the contract specifies the area allocated to the airline company, the fulfillment of the arrangement does not depend on the use of an identified space. The airport operator has a right to substitute the allocated space and this right is substantive because the operator also has a practical ability to change the allocated space. The entrance hall of the airport has several unoccupied places which will meet the airline company’s requirements, and the airport can change the space at any time without the airline company’s approval. Also, the operator will benefit economically by substituting the space. The airport operator needs to incur minimal costs for changing the allocated space.

However, if the airport operator did not have a substantive right/practical ability to substitute the allocated space, then the fulfillment of the arrangement will depend on the use of an identified space. In this scenario, the arrangement is likely to contain a lease.

How we see it

Determining when a customer has the right to direct the use of an identified asset may require significant judgement, particularly for arrangements that include significant services. While the new standard provides new criteria for determining whether an arrangement meets the definition of a lease, we expect that entities generally will reach similar conclusions as they do today.
**Lessee accounting**

**Initial recognition and measurement**

Lessees are required to initially recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments to be made over the lease term. The right-to-use asset is initially measured at the amount of the lease liability and adjusted for lease prepayments, lease incentives received, the lessee’s initial direct costs and an estimate of the restoration, removal and dismantling costs.

Lessees are permitted to make an accounting policy election, by class of underlying asset, to apply a method such as Ind AS 17’s operating lease accounting and not recognize lease assets and lease liabilities for leases with a lease term of 12 months or less (i.e., short-term leases). Lessees also are permitted to make an election, on a lease-by-lease basis, to apply a method similar to current operating lease accounting to leases for which the underlying asset is of low value (i.e., low-value assets).

**Subsequent measurement**

Lessees accrete lease liability to reflect interest and reduce the liability to reflect lease payments made. The related right-to-use asset is depreciated in accordance with Ind AS 16 Property, Plant and Equipment. For lessees that depreciate the right-to-use asset on a straight-line basis, the total of interest expense on lease liability and depreciation generally results in higher total periodic expense in the initial periods of a lease.

Right-to-use assets are subject to impairment testing under IAS 36 Impairment of Assets.

**Presentation**

Right-to-use assets are either presented separately from other assets on the balance sheet or disclosed separately in the notes. Similarly, lease liabilities are either presented separately from other liabilities on the balance sheet or disclosed separately in the notes. Depreciation expense and interest expense cannot be combined in the statement of profit and loss.

**Lessor accounting**

**Sale and leaseback transactions**

A seller lessee and a buyer lessor use the definition of a sale from Ind AS 115 to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, the transaction will be accounted for as a financing by both the seller lessee and the buyer lessor.

**Example**

An airline company sells a 10-year used aeroplane to another party (lessor) for INR100 million. On the date of sale, the aeroplane has a carrying amount of INR50 million in the financial statements of the airline company. On the same date, the lessor leases the aeroplane back to the airline company for a term of 7 years. The lease agreement does not contain any repurchase obligation or any call or put option. The agreement does not contain any option to renew the lease after initial lease period. The present value of the 7-year leaseback rentals is INR70 million.

**Evaluation**

At the inception of the lease, the present value of the leaseback rental is equal to 70% of the aeroplane’s fair value. Thus, the airline company has sold 30% of the residual interest. Consequently, it recognizes a right-to-use asset of INR35 million, i.e., 70% of the carrying amount before sale (the portion retained). It recognizes a gain of INR15 million on the sale of residual interest. This is equal to 30% of the difference between the fair value (INR30 million) and the book value (INR15 million) of the portion sold.

However, if in the above example the airlines had an obligation to purchase the aircraft back, then Ind AS 115 requires the sale and leaseback transaction to be accounted for as financing instead of a sale. A financial liability would be recorded in accordance with Ind AS 109, instead of derecognizing the aircraft.

**How we see it**

The new determination of whether a sale has occurred in a sale and leaseback transaction is a significant change from the current practice. For example, Ind AS 17 focuses on whether the leaseback is an operating or finance lease, and does not explicitly require the seller-lessee to determine whether the sale and leaseback transaction meets the condition for the sale of the asset. We generally expect fewer transactions to be accounted for as sales and leasebacks under the new standard.
Transition

The new standard permits lessees to use either a full retrospective or a modified retrospective approach on transition for leases existing at the date of transition, with options to use certain transition reliefs.

Key impact for the airline industry

The funding/PPE structure of airline companies across the globe is likely to differ significantly, with some companies financing aircrafts under a longer term finance lease or mortgage finance arrangements, while others may have entered into relatively short operating lease arrangements. For airline companies having large operating lease portfolios, Ind AS 116 is likely to have a significant impact. In addition, airline companies may have acquired properties and/or other tangible assets under operating lease arrangements such as landing slots. Accounting for such arrangements will also change. Given below is an overview of the key impacts for an airline company that has significant operating leases:

Increase in balance sheet size

Under Ind AS 116, leases previously treated as operating leases will generally now be recognised on-balance sheet. A lessee will recognise a right-of-use asset and a lease liability. The consequence is that it will recognise depreciation and interest expense in P&L, instead of lease rental recognised earlier. The limited recognition exemptions are given only for leases with a lease term of 12 months or less and leases of assets having low value. These exemptions are unlikely to be of much relevance for an airline company.

P&L volatility arising from foreign currency leases

Many aircraft leases are denominated in USD, which is likely to be a currency different from the functional currency of most Indian airline companies. Ind AS requires foreign currency lease liabilities to be retranslated at each reporting date and resulting gain or loss is typically recognised in P&L. This will create significant volatility in the P&L of Indian airline companies. Companies may wish to consider their treasury strategy and whether they are able to apply hedge accounting to address this volatility.

Impact on KPIs

The new accounting treatment will have significant impact on a range of key metrics such as:

- Net debt and gearing - Increases, as lease liability included in net debt
- Net assets - Decreases as the right of use asset amortises on a straight line basis while lease liability is unwound more slowly in early years
- EBITDA - Increases as rental expense replaced by interest, depreciation and amortization
- Cash flow from operating activities - Normally increases as interest will form part of financing activity

Next steps

Ind AS 116 will be a significant change from current Ind AS, in particular for lessees. Entities should perform an assessment as soon as possible to determine how their lease accounting will be affected. Entities will also need to ensure that they have the processes (including internal controls) and systems in place to collect the necessary information to implement the new standard.

Although accounting treatment is generally not the major driver for business model and strategy, the lessee’s operational decision to buy or lease the asset may change since the new leasing standard will not differentiate the accounting treatment that lessee is required to follow for operating or finance leases. The strategy of lessor may need to change accordingly.