THE CFO BOARD

Implementing *Ind AS 116* - Leases

An analysis of the key considerations for Corporate India

December 2019

The CFO Board is India's pre-eminent body of financial leaders and includes foremost CFOs in the country as members. The CFO Board debated the key issues arising from the implementation of the new accounting standard on Leases, covering both the financial reporting as well as the broader areas beyond financial reporting that have been impacted. The issues have been examined from corporate India’s perspective with support from KPMG in India.

This whitepaper is meant to serve as a high level analysis of some of the key issues that are relevant both for CFOs in the industry as well as for policy makers and regulators to consider as these new requirements are implemented in India.

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Introduction and background

The Ministry of Corporate Affairs (MCA) notified Indian Accounting Standard 116 (‘*Ind AS 116*, Leases, a new leasing standard on 30 March 2019 which replaces the existing standard on leases i.e. *Ind AS 17*, Leases with effect from accounting periods beginning on or after 1 April 2019. This new standard brings all leases on-balance sheet for lessees. All entities that lease major assets for use in their business will see an increase in reported assets and liabilities. It introduces a single on-balance sheet accounting model that is similar to the earlier finance lease accounting model. Therefore, majority of operating leases will be on-balance sheet as if the entity has incurred a liability to purchase an interest in the leased asset.

Global change impacting India

The adoption of *Ind AS 116* in India was not an India specific move, but the result of the convergence of the Indian requirements with International Financial Reporting Standards (‘IFRS’). In January 2016, the International Accounting Standards Board (IASB) issued IFRS 16, Leases – realising its long-standing goal of bringing all leases on-balance sheet for lessees.

Globally, the accounting change for entities following US GAAP or IFRS is applicable from 1 January 2019 with earlier application permitted in certain circumstances. The MCA notification closely aligns the applicability date in India with that of the global accounting change on leases.

Reasons for change

In the light of feedback that the previous lease accounting model for lessees failed to meet the needs of various stakeholders, the IASB, together with the Financial Accounting Standards Board (FASB), the US national standard-setter, (together 'the Boards'), initiated a joint project to review and improve the financial reporting of leasing activities under IFRS and US Generally Accepted Accounting Principles (US GAAP). In particular:

- The existence of two different accounting models for lessees, in which assets and liabilities associated with operating leases were not recognised on the balance sheet but were recognised for finance leases, meant that transactions that were economically largely similar could be accounted for very differently depending on the terms of the arrangements. The differences reduced comparability for users and provided opportunities to structure transactions to achieve a particular accounting outcome.

- Information reported about operating leases lacked transparency and did not meet the needs of users of financial statements. Many users adjusted a lessee's financial statements to capitalise operating leases because, in their view, the financing and assets provided by leases should be reflected on the statement of financial position ('balance sheet').

Sectors impacted heavily

This accounting change will affect a wide variety of sectors, from airlines that lease aircraft to retailers that lease stores. The larger the lease portfolio, the greater the impact on key reporting metrics. In addition to airlines and retail sector, companies operating in sectors such as telecommunications, travel and leisure, transport and logistics, media, hospitality and financial services are expected to be heavily impacted on transition to this standard.

No change in lessor accounting

The changes in the new leasing standard are not significant for lessors and, except in respect of sub-leases, a lessor is not required to make any adjustments on transition for leases in which it is a lessor. There are some changes in guidance for lessors relating to sub-leases, lease modifications and disclosures.

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Key changes vis-à-vis the current practice

In practical terms – what changes for companies as lessees?

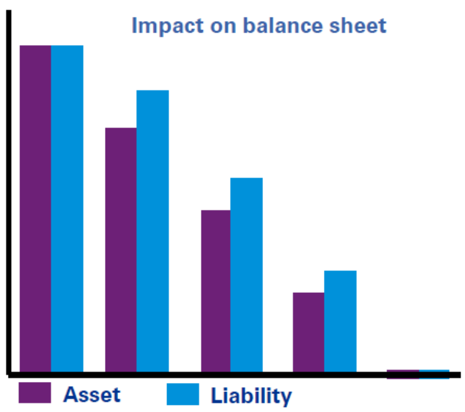
The new standard eliminates the classification of leases as either finance or operating lease as required under *Ind AS 17* from a lessee's perspective. A lessee is required to recognise a 'right-of-use' ('ROU') asset along with a lease liability on its balance sheet if it has the right to control the use of an identified asset in a contract (similar to current finance lease accounting model).

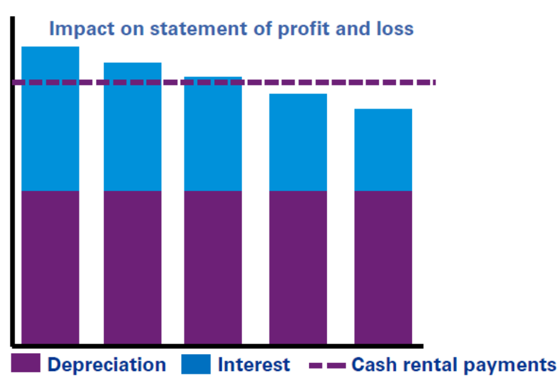
Impact on balance sheet and profit and loss

A lessee would be required to recognise a ROU asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Balance sheet of the lessee would be significantly grossed up i.e. companies with operating leases will appear to be more asset-rich, but also more heavily indebted.

Total lease expense in the statement of profit and loss would be front-loaded though cash rentals would remain constant over the period of the lease.

The impact on balance sheet and profit and loss over the life of the lease can be understood through the below graph:





There are only two exceptions to the above general requirement for lessees; these are for short-term leases and low value leases.

Impact on key reported figures

With additional reporting of assets and liabilities, key financial metrics such as Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA), asset turnover ratio, interest coverage ratio, etc., would get affected.

Lease rentals which were earlier accounted for under operating costs, will now be recognised as depreciation and finance cost. This will lead to increase in EBITDA, however, profit after tax (PAT) will be lower in initial years as interest cost will be front loaded.

In the cash flow statement, lease payments will be classified as cash flows from financing activities, leading to increased cash flows from operating activities without any change in total cash flows.

Impact on lessor accounting

As stated earlier, lessor accounting in *Ind AS 116* is largely consistent with that under the previous accounting standard with additional guidance in some areas.

A lessor classifies a lease as either a finance lease or an operating lease as per the classification tests laid based on a risks and rewards model which is essentially unchanged from *Ind AS 17* although they would have to apply the new leasing definition under *Ind AS 116*.

Ind AS 116 largely eliminates sale-and-leaseback transactions as a potential source of off-balance sheet finance. With respect to sub-leasing, an intermediate lessor determines the classification of the sub-lease with reference to the ROU asset arising from the head lease. Further, disclosures required from lessors have been enhanced under *Ind AS 116*.

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Important elements of the new lease accounting model

The new leasing standard sets out a comprehensive model for identification of lease arrangements and their treatment in the financial statements of both lessees and lessors. Some of the key elements of the new leasing standard have been evaluated in further detail below.

Lease definition

As per *Ind AS 116*, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration. Although, the new standard moves away from the risks and rewards model to a control model, for majority of contracts, the classification as lease or service contract may not be different under *Ind AS 116* as compared to *Ind AS 17*.

A lessee would need to consider following aspects of the lease:

- Is there an identified asset?
- Does the lessor have substantive substitution rights?
- Would lessee obtain substantially all of the economic benefits from use of the asset?
- Who has the right to direct the use of the asset i.e. who takes the 'how and for what purpose' decisions?

Lease term

Lease term is defined as the non-cancellable period in the agreement alongwith the periods covered by renewal and termination options based on lessee's assessment of how certain he is to exercise those options.

Lease term is a key estimate under the standard which would require careful consideration and application of significant judgment in a lot of cases, as a higher lease term will lead to higher lease liability and vice-versa.

Discount rate

Lessees calculate the present value of the lease payments using the interest rate implicit in the lease. This is the rate that causes the present value of the lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

If the lessee cannot readily determine the interest rate implicit in the lease, then the lessee uses its incremental borrowing rate. This is the rate that a lessee would have to pay on the commencement date of the lease for a loan of a similar term, and with similar security, to obtain an asset of similar value to the ROU asset in a similar economic environment.

Discount rate and lease liability value are inversely proportional to each other and it makes the lease liability calculation very sensitive. Hence careful consideration should be accorded to the same.

Lease and non-lease components

If a contract is, or contains, a lease, then the company accounts for each separate lease component, separately from non-lease components. The allocation is done on the basis of relative stand-alone selling price of each lease component and aggregate stand-alone price of non-lease components.

To optimize the effort in implementing the standard, the new standard provides an option to lessees (to be elected by class of underlying asset) not to separate lease components from any associated non-lease components. If a lessee elects this option, it capitalises accounts for the lease component and the associated non-lease components as a single lease component. Else, it accounts for non-lease components in accordance with other applicable standards.

This is a very significant policy option under the standard as it directly impacts the lease liability value.

Short-term and low value exemption

Ind AS 116 provides an option to continue the operating lease style accounting for leases with a lease term of 12 months or less that do not contain a purchase option i.e., short term leases (on a lease-by-lease basis) and leases for which the underlying asset is of low value when it is new (on a class of asset basis), even if the effect is material in aggregate. In other words, the leases that qualify for the above two exemptions may not be brought on the balance sheet of the lessee.

Lease modifications and reassessment

A lease modification is a change in the scope of a lease, or the consideration for a lease, or both, that was not part of the original terms and conditions of the lease – e.g., adding or terminating the right to use one or more underlying assets. There are detailed accounting considerations given in the new standard for dealing with various scenarios of lease modification. Further, reassessment of lease liability is also required in case of change in estimates like lease term, residual value guarantees, exercise of purchase option, variability in payments, etc. Some of these changes may also require management to make new estimates – e.g., discount rate for the remaining lease term on the date of modification.

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Impact beyond financial reporting

Impact on key financial and operational ratios and KPIs

Whilst the new standard does not change the overall cash flows and the economic benefits and risks of leasing, unless contracts are restructured, the new lease accounting model will change key evaluation metrics and key performance indicators (KPI).

Most commonly used financial ratios and performance metrics such as debt/ equity, asset turnover, interest cover, operating profit, earnings per share (EPS), return on capital employed (ROCE) and return on equity (ROE) will be impacted.

The following diagram represents the impact on some of the most commonly used ratios:

Favorable impact expected

- EBITDA/ Sales
- Asset/ EBIT
- Total assets
- Operating cash-flows

Adverse impact expected

- Debt/ EBITDA
- Debt/ Equity
- Interest Coverage Ratio
- ROE Flows
- EPS

Impact on banking and funding arrangements

As part of commitments to lenders, included within borrowing contracts, borrowers need to comply with certain covenants which include maintenance of certain financial ratios within a range. Many of these ratios are gearing ratios.

In view of the change in financial dynamics, the borrowing contracts may have to be amended. Further, banking and other lending institutions may have to redefine or recalibrate the commonly used covenants like leverage ratios and KPIs for evaluation of new borrowing proposals.

On transition to the new standard, there could be a one-time charge to retained earnings depending on the transition option elected. This may further narrow the gearing ratios of the entity which could impact the future borrowing ability of the company.

Further, ratios defined on a ‘Frozen GAAP’ basis in existing borrowing arrangements pose a different set of challenges. On the one hand, the existing loans are unaffected, evaluation and covenants of fresh borrowings would be under new definitions. Hence, borrowers may have to maintain two set of records depending on their arrangements with various lenders.

Impact on commercial arrangements

It will be important for companies to identify the commercial implications of the adoption of *Ind AS 116* and whether it triggers any changes to contractual arrangements. This would depend largely on a company's size and the business model.

While an accounting change should not be the driver of business and commercial decisions, there can be some impact on commercial arrangements leading entities to rework their business model or some elements of the same. Those business practices that have evolved with the objective of keeping assets and obligations off balance sheet will possibly be re-evaluated, as that objective will not be achieved anymore.

In many situations, companies will re-think about 'lease versus buy' decisions. In certain cases, companies are also using this transition as a trigger to review the commercial construct of some of their arrangements, including evaluation of models where the lessor has greater skin in the game with a significantly higher element of contingent rent, and so on.

Ind AS 116 will make widely used financing options like "sale and lease back" less attractive, as right-to-use asset and lease liability will have to be recognized in the books. Further, profit on sale of such transactions may also have to be spread over the lease term.

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Practical considerations and best practices in implementation

Significant estimates and judgements

The standard introduces new estimates and judgmental thresholds that affect the identification, classification and measurement of lease transactions. Senior staff will need to be involved in these decisions – both at lease commencement and at reporting dates, as a result of the continuous reassessment requirements. The most significant of the estimates and judgements are in relation to identification of leases, calculating lease term, determining discounting rates, etc.

Once the lease liability is recognised in the books, it requires continuous monitoring to reflect the changes in the agreements and management estimates. For lease contracts where the rentals are linked to the index, changes in the future index rentals will change and lease liability has to be recomputed. Similarly, there would be adjustments required in case of any re-assessment of lease term, variable payments become fixed or vice-versa, re-assessment of purchase option exercise, change in residual value, etc.

Data collation and computation challenges

Entities may face data collation and computational challenges at both transition date as well as at each reporting date. For entities having a large number of lease contracts, managing volume efficiently and accurately in spreadsheets may not be practical and it may be prone to error.

Systems and process changes may be required to capture the data necessary to comply with the new requirements, including creating an inventory of all leases on transition. The complexity, judgement and continuous reassessment requirements may require additional resources and controls, both automatic and manual, focused on monitoring lease activity throughout the life of leases.

Transition options

A key early decision is how to make the transition to the new standard. There are primarily 2 approaches in the standard i.e. retrospective and modified retrospective approach for transition. Retrospective approach requires an entity to apply the new leasing standard as if it was always being followed and requires restatement of previous year financial statements and opening retained earnings of the earliest period presented.

Under modified retrospective approach, an entity

- calculates lease assets and lease liabilities as at the beginning of the current period using special rules included in the new standard;
- does not restate its prior-period financial information;
- recognises an adjustment in equity at the beginning of the current period;

There are various practical expedients/ options given to an entity on transition which include grandfathering of lease assessment for existing contracts. All the other practical expedients on transition are for lessees and most of them apply if an entity chooses modified retrospective option only.

For many companies, the choice of transition method and which practical expedients to apply will have a major impact on the cost of implementing the standard and the comparability of trend data in the years after transition.

Mitigating the impact

While there are many evolving practices, some of those that are in vogue are discussed below:

Alternate structures being used by entities

- Create lease structure such that lease payments are contingent in nature like lease rentals as a "%" of sales.
- Enter into long term leases having more than 60 years to minimize the impact in the P&L
- Enter into management contracts rather than leases
- For small assets like vehicle, office equipment - enter into short term leases or cancelable leases.
- Explore possibility of leases linked to occupancy or usage

Approaches in Investor engagement and M&A valuation multiples

Amongst the variables, ratios and key figures analysed by investors and analysts, EBITDA, free cash-flow and profit after tax are key variables evaluated by them as multiples are applied to these figures to arrive at Enterprise Value. With these figures undergoing a change, the acceptable multiples in each industry/ sector would have to be relooked at. For ex: Enterprise value at a multiple of X of EBITDA before application of the standard may not hold good in the post transition scenario as EBITDA will go up without change in business fundamentals.

Many of the analysts are following a wait and watch strategy wherein they are awaiting the market to set the new multiples whereas some of the others suggesting a different benchmark such as EBITDAR i.e. earnings before interest, taxes, depreciation and amortization and rentals. Analysing EBITDAR trend essentially neutralizes the impact of transition to the new standard.

Areas requiring clarity

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Financial reporting – presentation and classification

Ind AS 116 requires lessees to present ROU assets separately in the balance sheet. Another option is to include the ROU assets in the same line item in which the underlying assets would have be presented if they were owned, and requires the lessee to disclose the relevant line items in the balance sheet. In such a case, lessee will have to give further details in the notes to financial statements. In the absence of specific guidance in *Ind AS 116*, entities may have to await revision of Schedule III to the Companies Act or a clarification thereof in this respect from the Ministry of Corporate Affairs ('MCA').

Ind AS 116 also requires lease liabilities to be disclosed separately from other liabilities but does not specify the line-item in the Balance Sheet to present them. Schedule III requires finance lease obligations to be disclosed under borrowings which essentially makes them financial liabilities. ICAI's guidance note on Ind AS has referred to appropriate regulatory authorities to provide guidance/ clarification of presentation of lease liabilities. In the absence of detailed guidance, companies may have to either await clarification or observe the practices that develop over time to relating to classification and disclosure of lease liabilities in the balance sheet.

Income Taxes

As regards the direct tax implications, there are no specific provisions under the Income Tax Act, 1961 ('the Act'), which provides for the taxability arising pursuant to the lease transactions. Amongst others, in a leasing arrangement, the issue of allowability of depreciation (in the hands of the lessor vs in the hands of lessee) has always been a bone of contention between the taxpayer and the revenue authorities. The judicial debate around the issue of allowability of depreciation involves an interplay with the accounting principles.

Under Section 32 of the Act, two conditions of ownership and usage for business and profession of the taxpayer are given for the purpose of claiming depreciation. The tax controversy with respect to claim of depreciation in relation to leased assets inwardly revolves around the ownership of the asset for which one needs to examine the underlying terms and conditions of the lease deed. The classification in the books of account and accounting entries therein are not by itself determinative of the tax treatment[1].

Under pre-*Ind AS 116* scenario, if as per the terms and conditions of the lease deed, the lessor is considered as the owner of the asset, it has been held that the lessor is entitled to depreciation under the Act[2]. This is generally undisputable in case of an

1. Kedarnath Jute Mfg Co Ltd. (1971) 82 ITR 363 (SC); CBDT Circular No. 2/2001
2. I.C.D.S. Ltd. (2013) 29taxmann.com129 (SC); K.M. Sugar Mills Ltd. (2015) 57taxmann.com68 (SC); Prakash Leasing Ltd. (2012) 23taxmann.com35 (Kar)

operating lease as the lessor is the legal as well as economic owner of the asset in such a case. However, the issue of determining the real ownership of the asset, particularly when the lease has been classified as a finance lease[3] in the books of account, has always been an elephant in the room.

While the judicial debate closely revolves around the fact pattern of each case, judicial support is available with respect to allowability of depreciation to the lessee in case of a finance lease . The underlying essence of these cases is that having regard to the terms and conditions of the lease agreement, it is the lessee who is considered as the actual or real owner of the leased asset and lessor is only a nominal or a symbolic owner. The issue is however, not free from doubt and time and again lessee's claim of depreciation has been challenged by the revenue authorities. The matter is sub-judice before the higher appellate authorities and yet to attain finality.

The position that in case of a finance lease, depreciation should be allowed to the lessee was explicated in Direct Taxes Code Bill, 2010 ('DTC Bill') for the first time. Subsequently, in 2015, the draft Income Computation and Disclosure Standard (ICDS) on Leases released by the Central Board of Direct Taxes ('CBDT') also provided that the lessee (and not the lessor) shall be entitled to depreciation in case of an asset acquired under the finance lease. In fact, the draft ICDS contained detailed provisions with respect to the over-all tax treatment of leases in the hands of the lessee as well as in the hands of the lessor. Nevertheless, neither the DTC Bill, nor the ICDS on leases eventually materialized and the matter continues to be a subject of judicial debate.

It is worthwhile to note that as per ICDS IX on borrowing cost, the finance charges in respect of assets acquired under finance leases or under other similar arrangements are regarded as borrowing cost. The commencement and cessation of capitalization thereof is governed by the provisions of ICDS IX. Does this indirectly suggest that in case of a finance lease, the lessee needs to capitalize the asset and consequently, entitled to depreciation as well? The industry and the stakeholders still remain uncertain about the allowability of depreciation and await clarity on this aspect from CBDT.

Now, post-*Ind AS 116*, the classification of leases into operating and finance lease continues for a lessor whereas it has been purged for lessees. Effectively, in a lease classified as operating lease by a lessor, the depreciation shall be charged in the profit and loss account both by the lessor as well as lessee. However, in a lease classified as finance lease by a lessor, no depreciation shall be charged by the lessor (the charge of depreciation shall appear only in the books of the lessee).

No specific provisions have been introduced under the Act to address the aforesaid accounting development (either under the normal provisions or under the provisions of section 115JB of the Act). Accordingly, until further developments, the position of law / judicial principles in the *pre-Ind AS 116* would continue to dominate the tax treatment in the hands of the lessor and the lessee. Nevertheless, there are various inherent ambiguities in the tax treatment which need specific clarifications (either through legislative amendments or otherwise). Some of those under normal tax provisions are highlighted below:

- Who is entitled to depreciation - whether the lessor or the lessee and in what circumstances?
- Whether the ROU asset as capitalized in the books of the lessee under *Ind AS 116* can be regarded as an intangible asset under the block of assets concept under the Act?

Implications under MAT – Section 115JB of the Act is a code in itself which prescribes the computation of Minimum Alternate Tax ('MAT') on the basis of book profits of the Company with certain adjustments specified. On transition to Ind AS, section 115JB was amended to prescribe that 1/5th of the amount adjusted in the other equity upon first time adoption of Ind AS shall be adjusted to the book profits over a period of five years beginning the year of initial application. Now, theses above provisions of section 115JB(2C) of the Act may not applicable with respect to transition adjustments that entities make to retained earnings as at 1 April 2018 or 1 April 2019 (depending on the transition approach chosen).

In absence of any specific provision in section 115JB of the Act in this regard, the adjustment to retained earnings pursuant to adoption of *Ind AS 116* cannot be given effect to while computing the book profits. Further, while computing book profits under section 115JB of the Act, depreciation on revalued assets is not eligible for a deduction. Whether the change in depreciation charge pursuant to adoption of *Ind AS 116* can be contested by revenue authorities on the premise that this is pursuant to revaluation?

Other issues: Depending on the positions taken by the department and taxpayers, entities may have to maintain reconciliations between books of account with the numbers filed under Income Tax. In many jurisdictions, there are some stringent provision with regard to "thin capitalization" and the notional interest cost as accounted in the new lease standard may get disallowed.

Goods and Services Tax ('GST')

The term 'lease' has not been defined in the CGST Act, neither does the Act, differentiate between a finance lease transaction or an operating lease transaction. However, for the purpose of classifying whether a transaction classifies as supply of goods or supply of services, schedule II of the CGST Act,

3. Indusind Bank Ltd. (2012) 19taxmann.com173 (ITAT Mum - SB); J M Shares & Stock Brokers (2007) 109 ITD 329 (ITAT Mum); State Bank of India (2014) 44taxmann.com 99 (ITAT Mum)

prescribes certain guidelines in this regard. The guiding principle that can be inferred from the said guidelines for lease transaction is where a leasing agreement provides for transfer of title, the same would qualify as 'supply of goods' and in all other cases viz. lease, tenancy, easement, licence, right to use etc., without the transfer of title may be treated as the 'supply of services'.

Though for the purpose of Schedule II, lease transaction without transfer of title in goods are classified as 'supply of services', the rate of GST prescribed in Notification 11/2017 – CGST (Rate) is same as the rate applicable for 'supply of goods' except for leasing of aircrafts for operating scheduled air transport services or scheduled air cargo services.

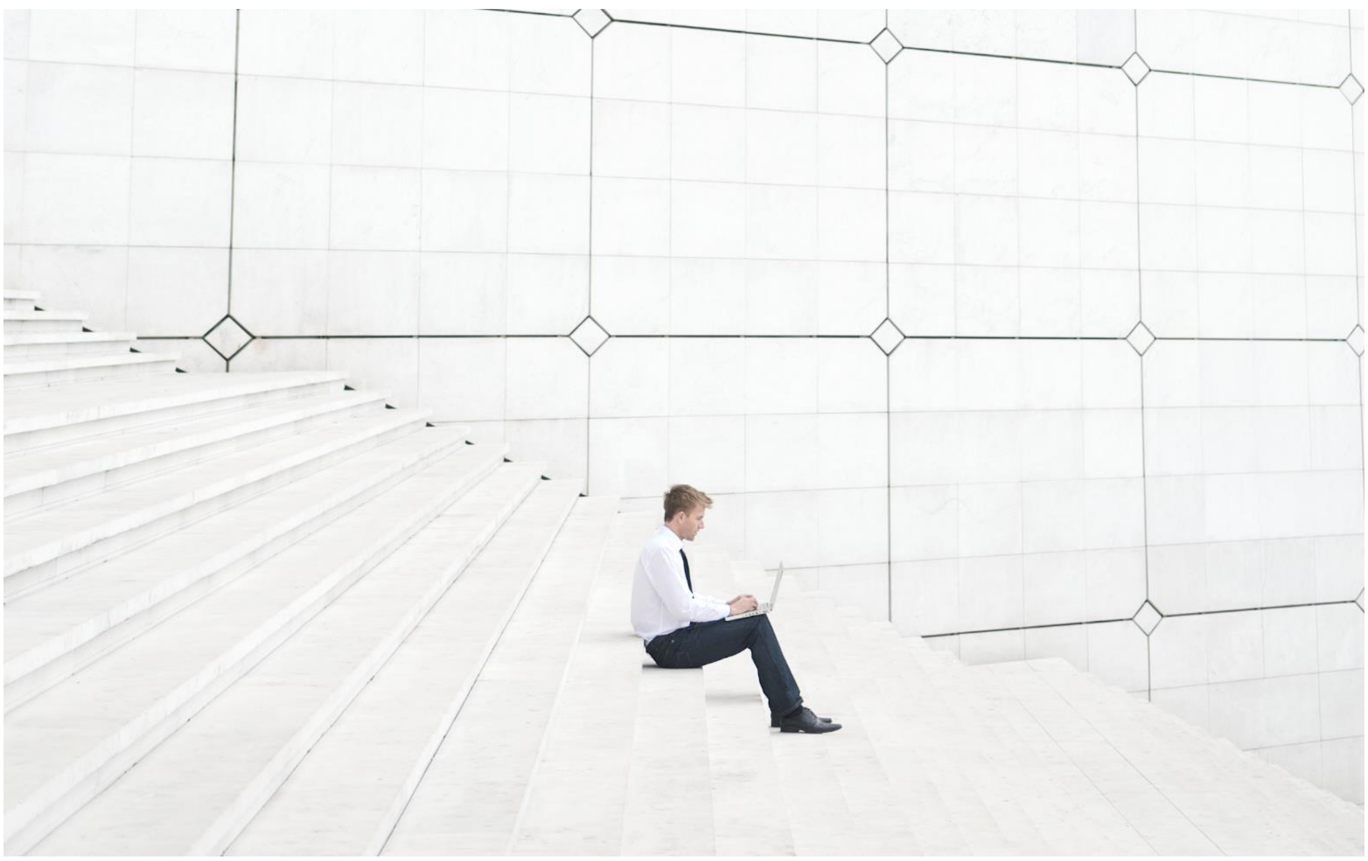
Prior to the new standard, the lease rental was expensed out by lessee and the entire GST on rental was claimed as input credit on a periodic basis. Post implementation of *Ind AS 116*, the GST credit should continue to be available to lessees subject to fulfilment of the conditions prescribed under the CGST Act and the rules made thereunder. However, the moot questions that may arise due to the treatment of such leased assets as capital goods are:

- Whether the determination of the eligible credit shall be determined basis the provisions contained for inputs/input services or those relating to capital goods; and
- Whether the lessee would be required to pay GST (reversal of credit) upon transfer of such lease assets back to the lessor upon completion of the lease period, by virtue of entry no. 1 "Permanent transfer or disposal of business assets where input tax credit has been availed on such assets" under schedule I of the CGST Act.

Based on GST provisions, credit should be considered as input/ input services and treatment should not change on account of disclosure in financials. However, considering different treatment in books, tax authorities may raise queries on the said transaction and accordingly the lessee may be required to submit adequate reconciliations.

GST administrators may take a view that leasing transaction is of capital in nature (due to lease capitalization) and all the GST provisions and rules relating to the capital asset will accordingly be applicable to lessees. In such a scenario, entire input credit may not be allowed or certain mechanisms for reversals of input credit which may be applicable. This may be a litigious matter in future and it is advised that a proper clarification is sought from the department in this regard.

The above change in the accounting treatment/disclosure in the books of accounts of the lessee should not have any impact on the levy of GST by the lessor.



07

Sectoral viewpoint – impacts and learnings

Telecom and telecom infrastructure

Telecom sector being asset-heavy, is expected to be severely impacted by this standard as telecom operators enter into a huge variety of asset sharing agreements with telecom infrastructure providers and customers which may be both long-term and short-term. Further, a lot of these agreements like indefeasible right-of-use of fibres, land and tower leasing and other leased lines can be for a long period which may lead to huge asset-liability in their books.

> Adoption of *Ind AS 116* brings parity between companies using their own funds vs companies paying rent.
>
> \- Hemant Kumar Ruia, CFO, Indus Towers

Impact on the sector is summarised below:

Headline assessment	The adoption of *Ind AS 116* had severe impact and is a practical nightmare for finance wherein they need to maintain two set of books. Also, it bloats the balance sheet and the rating agencies may have trouble in comparisons.
Financial impact	The impact was very significant. For some companies, the EBITDA increased by approximately 35% and the net block went up by approximate 30% in the balance sheet.
Business impact	The most impacted has been finance for whom the calculation of *Ind AS 116* entries is a nightmare with lakhs of rental contracts, each with multiple line items.
Commercial impact	For most companies, the standard has had no commercial impact as such.
Impact on KPIs and other metrics	Some of the companies have maintained the old format of reporting for MIS wherein rent is treated as an operating expense. This has led to difference between MIS and reported numbers.
Tax issues	No significant impact is anticipated
Challenges along the way	There were some significant interpretation challenges: 1. Incremental borrowing rate needs to match the tenor of the lease – it gets very difficult for companies to get incremental borrowing rate for all tenors having leases varying from 1 year to 20 years 2. No clarity on one-time lease payments or full and final settlement of leases and their treatment 3. Treatment of security deposit paid to landlords 4. Segregating lease and non-lease components 5. Asset retirement obligation treatment 6. Segregation of initial indirect costs
Investor engagement	Investors have faced difficulties in understanding the financial impact of the standard and how the financial statements have undergone a change due to that.

Hospitality

Most of the hotelier companies follow an 'asset-light model' as a capital allocation strategy and as a result it may have large number of properties on lease. These are expected to be significantly impacted by the changes in the new lease requirements.

Impact on the sector is summarised below:

> The new lease standard will bring in disruption in accounting and volatility in the Balance Sheet and Statement of Profit and Loss
>
> Giridhar Sanjeevi, CFO of IHCL

Headline assessment	Significant increase in the size of balance sheet and EPS of the Company. Though it's a 'zero-sum game' over the tenor of the lease but periodical medians and KPIs will look erratic, as expense in profit and loss account would be front loaded, however no change in underlying business.
Financial impact	The size of the balance sheet has increased dramatically due to the recognition of ROU assets and lease liabilities. For retrospective transition option, significant charge in retained earnings of the Company may impact dividend paying ability of the Company. Whilst the EBITDA and GOP margin looks better, however, due to front loading of the interest cost, PAT is lower and the resultant EPS. No impact in the cash but the operating cash flows looks artificially better due to shift of payment of lease liability (lease rental payouts) from operating to financing activity.
Business impact	No major impact on the business as such, however, as an operator, entities in this industry receive some of the incentives/ fee income which is linked to EBITDA. This may have to be re-looked and realigned, as the underlying business and cash flows have not changed or impacted. The accounting for lease cost which are contingent in nature remains the same like earlier standard. This element creates inconsistencies in benchmarking operating performance of the properties internally as well as externally even for similar leased properties, but with different commercials. Perhaps, industry might have to start looking at EBITDA (R) – R is Rent! This will lead to amendments in agreements.
Commercial impact	There may not be immediate change in the contracting in short run, but in long run we believe more and more contacts will be variable in nature i.e. rentals linked to the Income or other KPI's. Lessors will increasingly have more skin in the game and will be more like a long-term business partners than just a Lessors.
Impact on KPIs and other metrics	The new standard has distorted many of the KPIs like Debt to EBITDA, Debt to Equity, EPS whilst improving the EBITDA. Alternative measures will evolve over a period of time. Industry has started looking at EBITDAR and not only EBITDA.
Tax issues	No major impact expected. However, clarity is awaited from the relevant authorities, including MAT treatment of retained earnings movement on the transition date.
Challenges along the way	Areas involving significant judgments were discount rate and lease term. Lot of efforts on collating the required information. Significant time spend on the impact assessment to enable the management, audit committee and Board for election of transition options.
Investor engagement	The analysts and investor are finding it difficult to understand the impact of the new lease standard on the Balance Sheet and profitability of the Company. With the implementation of the new standard, EBITDA margin has increased artificially. Aspirations from EBITDA margin perspective will have to be revised and communicated to market. For the ease of readability of the financial information for the readers, we are presenting the results with and without the *Ind AS 116* impacts. This improves the comparability of the results for two different periods.

Aviation

Most airline companies finance aircrafts through off-balance sheet lease models, as a common practice in the aviation industry. In addition, other assets such as check-in kiosks, boarding gates, which are taken on lease from respective airport owners are also classified as operating leases.

Impact on the sector is summarised below:

> The new leasing standard brings all aircrafts on the balance sheets of all airline operators – thereby bringing the core operational assets on the balance sheets.
>
> Niyant Maru, CFO of Vistara Airlines

Headline	With all leases on the balance sheet, the assets and liabilities on the balance sheet have increased tremendously.
Financial impact	The new standard brings onto the balance sheet more USD debt given airline's current operating leases are usually priced in USD. This has also created more volatility in the financial statements as lease liabilities will be translated every balance sheet date.
Business impact	No major impact on the business as such. However, it is difficult for the business teams to understand the impact on financial statements and factor them into the MIS. This has thus created some differences in financial statements and MIS and resulted in reconciliation items.
Commercial impact	This has significantly restricted the sector's ability to purchase aircrafts and then package them into operating leases through sale and lease-back. More attention will have to be paid to whether there is exclusivity in the space taken in contracts with airport operators.
Impact on KPIs and other metrics	Although the new standard has improved the EBITDA, it has changed many of the KPIs like Debt to EBITDA, Debt to Equity and EPS as well.
Tax issues	No major impact expected. However, clarity is awaited from the relevant authorities, including the impact on MAT.
Challenges along the way	Areas involving significant judgments were lease term and lease and separating non-lease components. Significant time was spent initially on assessing the impact to enable the management to make appropriate policy choices
Investor engagement	We are continuously engaging with investors to enable them to understand the impact in right spirit.

Retail

Most rental contracts for retail outlets whether for individual outlets or high street stores are likely to qualify as leases, as such contracts will meet the key criteria for lease, which is having the right to control the asset and obtaining the related economic benefits from the use.

> The standard has brought about a striking difference between how a business operates vis-à-vis accounting.
>
> Giridhar Chitlangia, CFO of More Retail

Impact on the sector is summarised below:

Headline assessment	Deterioration of net-worth and ballooning of the balance sheet (due to recognition of ROU asset and lease liability) and increased troubles faced by the Business teams to understand the principle and implication on operational profitability.
Financial impact	The new leasing standard has significantly deteriorated the net-worth of the Company. The health and size of the balance sheet of the Company has been affected by inclusion of ROU asset and liability. There is adverse impact on the profitability due to delta between the rent expense and amortisation of ROU asset plus interest on lease liability.
Business impact	Business teams find it extremely difficult to understand the underlying principle and the resultant impact of the new leasing standard. In food and grocery retail, decisions on new store proposals and store viabilities is largely influenced by rent expense amongst other factors. They are very cognizant about the rent expense for the store rather than accepting it as a ROU asset and a corresponding liability to discharge. From a P&L reporting perspective, they would be glad to report the split of rent into ROU asset and interest cost below EBITDA. Still in all their discussions with business teams and CEO, rent is seen as an operating expense.
Commercial impact	No significant commercial impact.
Impact on KPIs and other metrics	There were no changes in business MIS and reporting
Tax issues	No significant tax issues anticipated.
Challenges along the way	Areas involving significant judgments were determining lease commencement date, lease inception date, rent free period and the discount rate. Disproportionate effort was spent on collating the required information for accounting of over 800 lease contracts.
Investor engagement	They are very sceptical on the impact the lease standard on the balance sheet of the Company. They are finding it extremely difficult to correlate the accounting of the rent vis-à-vis the amortization and interest charge on the financial statements. The theory is simple to understand but complex to fathom when they look at the quantum of impact on the financials.

Banking

The nature of leasing arrangements in financial services sector typically comprises of lease of branch premises, Automated Teller Machines (ATMs) and cash deposit machines. Further, financial services entities also lease IT assets including data centers, servers and photocopy devices, laptops and workstations in addition to leasing of of vehicles for use of employees.

> Bringing the 'Invisible' onto financial statements.
>
> Jaimin Bhatt, CFO of Kotak Bank

Impact on the sector is summarised below:

Headline assessment	• The severity is not expected to be material.
Financial impact	• The primary impact of the standard will be on EBDITA and Debt/ Equity ratios which are generally not the measures of profitability. • Banks have an extensive branch and ATM network due to which there will be following impact: • Balance sheet: Off balance sheet leases will now be recorded on the balance sheet on gross basis i.e. ROU asset and lease liability will be recognised. This will impact ROA and CRAR. • Impact on profitability: The overall impact may not be material but the other operating expenses may change due to *Ind AS 116*.
Business impact	• *Ind AS 116* will extend to the borrowers, who may have substantial operating lease commitments. The Bank will have to assess impact on this changed position on the debt covenants of the customer. • Internal trainings are a must for the business to review the impact on customers financials metrics.
Commercial impact	• Lease standard is not expected to have any impact on commercial arrangements.
Impact on KPIs and other metrics	• Grossing up the balance sheet will an impact on ratios like ROA, capital adequacy, liquidity coverage among others. • Regulatory guidance on the above issues is awaited.
Tax issues	• Difference between actual payments and reflection in the financial statements will result in reconciliation issues in direct and indirect taxes. • It will also result in another difference for computation of deferred tax.
Challenges along the way	• Determination of transition options, threshold for low-value assets and application of practical expedients. • Determination of lease term considering various leasing agreements • Determination of discounting rate • Implementation of appropriate IT systems including requirements related to year end disclosures • Reviewing impact on internal controls over lease processes and accounting.
Investor engagement	• Since Ind AS is not applicable to the banking legal entities, further clarity will is awaited to decide on timing of communication to investors.

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Conclusion and way ahead

As seen above, implementing *Ind AS 116* will have far reaching impacts and many of the impacts are beyond financial reporting. There are many challenges that CFOs may have to grapple with which were discussed in detail above. Some of the key challenges that this standard presents are summarised below:

Review of the population of leasing arrangements

There could be many contracts with a leasing element embedded in it like contract manufacture outsourcing, guaranteed purchase agreement, solar energy contracts, etc. Sale and lease-back contracts have to be very carefully examined under the new standard as the lease will come back on the balance sheet and this mode of transactions may become less attractive over a period of time. Further, entities may like to structure certain contracts in a particular manner considering the policy choices afforded by the standard.

New estimates and judgments

The standard introduces new estimates and judgmental thresholds that affect the identification, classification and measurement of lease transactions. E.g., use of discount rates, assessment of the lease tenor, judgements for the exercise of options, etc. Further, these will have to be continuously monitored for updates at each reporting period. This will require additional time and effort.

Balance sheet presentation

Although *Ind AS 116* does provide some guidance on presentation of - leased assets within tangible assets or as separate intangible assets and lease liabilities as debt/ borrowings. However, it may not be definitive and may leave scope for interpretation. It needs to be supplemented with some clarifications from the MCA on presentation as per Schedule III.

Volatility in reported numbers

The new standard introduces volatility in accounting for leased assets and liabilities for lessees, due to the requirements to reassess certain key estimates and judgements at each reporting date. Further, a lease contract which is denominated in foreign currency will create volatility in both the net liability and profit and loss on account of restatement at each period end. This may impact a company's ability to accurately predict and forecast results.

Control environment

In an entity where the number of lease contracts are very high, managing the volume with efficiency and accuracy in spreadsheet may pose significant challenges and it may be prone to error. Systems and process changes may be required to capture the data necessary to comply with the new requirements, including creating an inventory of all leases.

Changes in key financial metrics

Due to the shift of cost line and recognition of asset-liability, many of the KPI calculations will change drastically. The legacy accepted level of metrics will have to be redefined or undergo a complete overhaul. Perhaps, new metrics will evolve over a period of time!

Changes in valuation metrics

DCF valuations may become more complex, more sensitive to errors and will presumably lead to changes in the valuation of equity. Some of the thumb rule valuations metrics like EBITDA multiples or earning capitalization, etc. may have to undergo a transformation.

Banking and rating agencies

The most commonly used financial evaluation parameters used by Bankers, Rating Agencies will undergo significant changes and accordingly all the standard medians used by the rating agencies, analysts, etc. may have to be calibrated again.

The new uniform metrics of measurement have to be re-defined, it will evolve over a period of time. In the absence of historical information, it may take years to establish acceptable medians of measurement.

Direct tax implications

There are no clarifications from CBDT on the tax treatment of leasing transactions in the post *Ind AS 116* scenario. Further, there are a number of ambiguities in the current practice as far as direct tax is concerned. Further, there is no ICDS issued on lease standard. CBDT may come with certain clarification on this. Till that time, entities may have to fall-back on the positions as existed pre-*Ind AS 116* scenario and disregard all adjustments made under *Ind AS 116* for tax compliance purposes.

MAT – Until the current provisions under section 115JB of the Income Tax Act, 1961 dealing with transition impact on accounting change is amended, any charge to the retained earnings on account of this standard may be lost permanently if a company falls under MAT.

Indirect tax implications

GST department may take the view that leasing transactions are of capital nature and all the GST provisions and rules relating to the capital asset will be applicable for this. In such a scenario, entire input credit may not be applicable or certain mechanisms for reversals of input credit may be applicable. This may become a litigious matter in future and it is advised that a proper clarification is sought from the department in this regard.

This report has been prepared by The CFO Board, under the guidance of Mr. Giridhar Sanjeevi, Mr. PK Ghose, and Mr. Anil Parashar, along with other members of The CFO Board, with support from Mr. Sai Venkateshwaran, Mr. Dinesh Jangid and Mr. Vaibhav Poddar of KPMG in India. Mr. Krishnan Narayanan, Ms. Parul Mehta and Mr. Kirti Oswal also supported in the preparation of this note.

For further queries on this report, please contact secretariat@cfoboard.com.