IFRS 16/IND AS 116 'Leases': Off Balance Sheet to On Balance Sheet, Implications for the Capital Market

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The Metamorphosis[1]

International Financial Reporting Standard (IFRS) 16, Leases, replacing the erstwhile International Accounting Standard (IAS) 17, has ushered in a revolution in lease accounting and reporting from the perspective of the lessee. It is effective for annual reporting periods beginning on or after 1 January 2019, with earlier application permitted. IFRS 16 introduces a single lessee accounting model, going away from *twin lease accounting models of finance lease and operating lease*, and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. The distinction between an operating lease and a finance lease, which are explained below, has been withdrawn for the lessee for the purposes of accounting and financial reporting.

Operating lease: A lease where the lessee uses the leased asset, say a building, for the agreed period in consideration of periodic lease rentals. The ownership continues with the lessor. Lessee simply uses the asset for its business and return the same to the lessor at the end of the lease period.

Finance lease: A lease where substantially all the risks and rewards incidental to ownership of an underlying asset are transferred to the lessee. Thus the lease rentals include recovery of principal cost of the asset and interest on the outstanding dues. At the end of the lease term the *ownership of the asset is transferred* to the lessee. This lease in effect is a borrowing and lending arrangement.

A lessee is now required to account and report for operating lease on the same lines as a finance lease. Thus lessee has to recognise the asset taken on lease as a Right-of-Use Asset (ROU Asset) representing its right to use the underlying leased asset and recognise a lease liability representing its obligation to make lease payments. A lessee measures ROU Assets similar to other non-financial assets (such as property, plant and equipment) and lease liabilities similarly to other interest carrying financial liabilities, that is, borrowings. As a consequence, a lessee recognises depreciation of the ROU Asset and interest on the lease liability. Right-of-Use Asset (ROU Asset) is a new term coined by IFRS 116 for leased asset.

This model has far reaching impact on the financial performance, financial position and cash flows of an entity as all of them will undergo substantial transformation with radically different results. This will result in to strengthening the assets side and reduce debt raising capacity for the business plans. It may thus bring the real capital structure to the fore thus adversely affecting the growth of businesses. However, it will protect the entities from taking the risk of over-leveraging and ultimately enable them attain a sustainable business model creating value for the stakeholders.

India also followed the suit. It replaced its earlier lease accounting standard IND AS 17 by a new standard IND AS 116. The Ministry of Corporate Affairs (MCA), Government of India, notified the new standard vide its GSR (E) dated 30th March 2019 making it obligatory with effect from 1st April, 2019. IND AS 116 is in substance fully convergent with IFRS 16 and contains similar principles and requirements for lease accounting and reporting by a lessee.

Substance Over Form

This new model is supposed to be based on the principle of **substance over form**. In an operating lease transaction, the leased asset is owned by the lessor and given to the lessee only for his use. That is the technical form of the transaction. However, the economic reality is that for all practical purposes the lessee exercises full control over the asset and therefore he should disclose this asset in his balance sheet, of course as a leased asset. That is the substance of the transaction. Thus the off balance sheet asset/liability should be brought on the balance sheet. Thus this window of window dressing should be shut. In the present era of fair value reporting form is gradually taking a back seat giving way to substance to occupy the front seat. In this context, it will be worthwhile to refer to the objective of new lease accounting model as contained in IFRS 116/IND AS 16:

- "This Standard sets out the principles for the Recognition, Measurement (Valuation), Presentation and Disclosure of Leases.

- The objective is to ensure that lessees and lessors provide relevant information in a manner that **Faithfully and Truly** represents those transactions.
- This information gives a basis for users of financial statements to **assess the effect that Leases have** on the Financial Position, Financial Performance and Cash Flows of an entity".

Complexities

But it is easier said than done. Applying the new model is not as simple as it seems to be. Detailed guidelines have been laid down in IFRS 116/IND AS 16 in this regard which need to be apprehended by the finance professionals. There are many managerial implications involved. Valuation of leased asset, despite there being no actual purchase, and of corresponding deemed borrowing are tricky issues. Ascertainment of interest payable despite there being no actual borrowing is another big issue. The biggest and the most challenging is the appearance of a long term borrowing liability on the balance sheet. It may adversely disturb the existing debt equity ratio and scale down the fund raising capacity of the business. Existing expansion plans could thus be jeopardized and the businesses might have to chalk down their fund raising plans afresh. The lending institutions could pressurize the over leveraged borrowers to either infuse more equity or sacrifice a part of the existing loans. This could affect the bottom line adversely.

A Case Illustrated

Let me illustrate and sum up the above discussion through a simple case:

- Lessee: X Ltd.
- Asset taken on lease for 12 years (ROU asset): Godown building
- Lease commencement date: April 1, 2020
- Annual lease rental payment: Rs. 6 crores as at the year end with escalation of simple 5% every year.
- Discounting rate (Incremental borrowing rate of X Ltd.): 11% PA. This is the rate of interest that X Ltd. would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the ROU Asset in a similar economic environment.
- Depreciation: Straight line method.

A. Treatment under erstwhile IAS 17/IND AS 17:

(**Note**: Detailed computations have not been shown here.)

- Total lease rentals payable over 12 years: Rs. 91.80 crore.
- Yearly average: Rs. 7.65 crore.
- Charge to profit and loss statement: Rs. 7.65 crores as rental expense during 2020-21 and every subsequent year. The standard required the lessee to annualize the rentals on a straight line basis.
- The Godown Building asset lying off the balance sheet.

B. Treatment under IFRS 16/IND AS 116

(**Note**: Again, detailed computations have not been shown here.)

- Lease rentals not to be charged to the statement of profit and loss. Instead they to be used as a basis for determining the deemed value of the ROU asset and corresponding Borrowing (lease liability), as if the ROU asset was acquired through borrowing.
- **Initial** valuation of ROU asset and lease liability (Non-current Loan) on April 1, 2020: Equal to present value of lease payments. Thus Rs. 91.80 crores discounted @ 11% yielding a deemed value of Rs. 47.31 crores. Same is deemed to be the lease liability to be paid over 12 years. Thus lease rentals of Rs. 91.80 crores will be bifurcated in to repayment of principal lease liability and interest thereon. Therefore, the total deemed interest payable comes to Rs. (91.80 minus 47.31) crores, that is, Rs. 44.49 crores.
- **Subsequent** measurement of ROU Godown building on 31st March year end will be at cost less depreciation. SLM Depreciation: 47.31/12 = 3.94 Crore PA. Value of leased asset as on 31st March, 2021: Rs. 43.37 crore.
- **Interest** charge on lease liability for 2020-21: 47.31*11% = Rs. 5.20 crore. Actual lease rental paid: Rs. 6.00 crores. Hence repayment of lease liability = 0.80 crores (6.00 minus 5.20).
- **Subsequent** measurement of lease liability on 31st March, 2021: (47.31 minus 0.80) = 46.51 crores.

C. Transformation in the financial statements:

This entire treatment is now summarized for the first financial year ended 31st March, 2021 financial statements.

Treatment Now Per IFRS 16/IND AS 116			Earlier treatment, Per IAS 17/IND AS 17	
	Rs. Crore		Rs. Crore	
Statement of profit and loss				
Expenses:				
• Depreciation on ROU asset	3.94		Lease rental	6.00
• Interest on lease liability	5.20	9.16	NA	0.00
Balance sheet				
Assets: ROU Godown building	43.37		NA	0.00
Liabilities: Lease liability (Loans)	46.51		NA	0.00

D. Strategic Impact on the business plans of the company and the capital market

- Expenses increased by Rs. 3.16 crore (9.16 Minus 6.00) in the first year. Profit decreased to that extent. Resultantly, EPS and NAV to go down. Correction to take place in the stock price.
- Balance sheet size strengthened. ROU asset and the corresponding lease liability (Non-current loan) now brought to the balance sheet, showing a transparent view of resources and obligations of the company. Asset cover for further borrowings increased.
- However, lease liability (Non-current loan) to increase the existing debt equity ratio. To that extent company will be restrained from raising further loans. It will have to resort to higher equity for its expansion/diversification plans. Equity is costlier than debt and again therefore it will negatively affect the EPS.
- Overall the company will have to redesign its future funds requirements and financing structure which have a crucial bearing on its business plans and strategies.
- Finally, capital market will be able to discover a more accurate stock price.

Conclusion

IFRS 16/IND AS 116 are thus very investor friendly financial reporting standards. They put substance over form and bring transparency in the financial reporting, so essential for a healthy development of the capital market.

[1] **Note**: The author may be reached at ambrish@fsm.ac.in. The views expressed here are his personal and not those of FORE.