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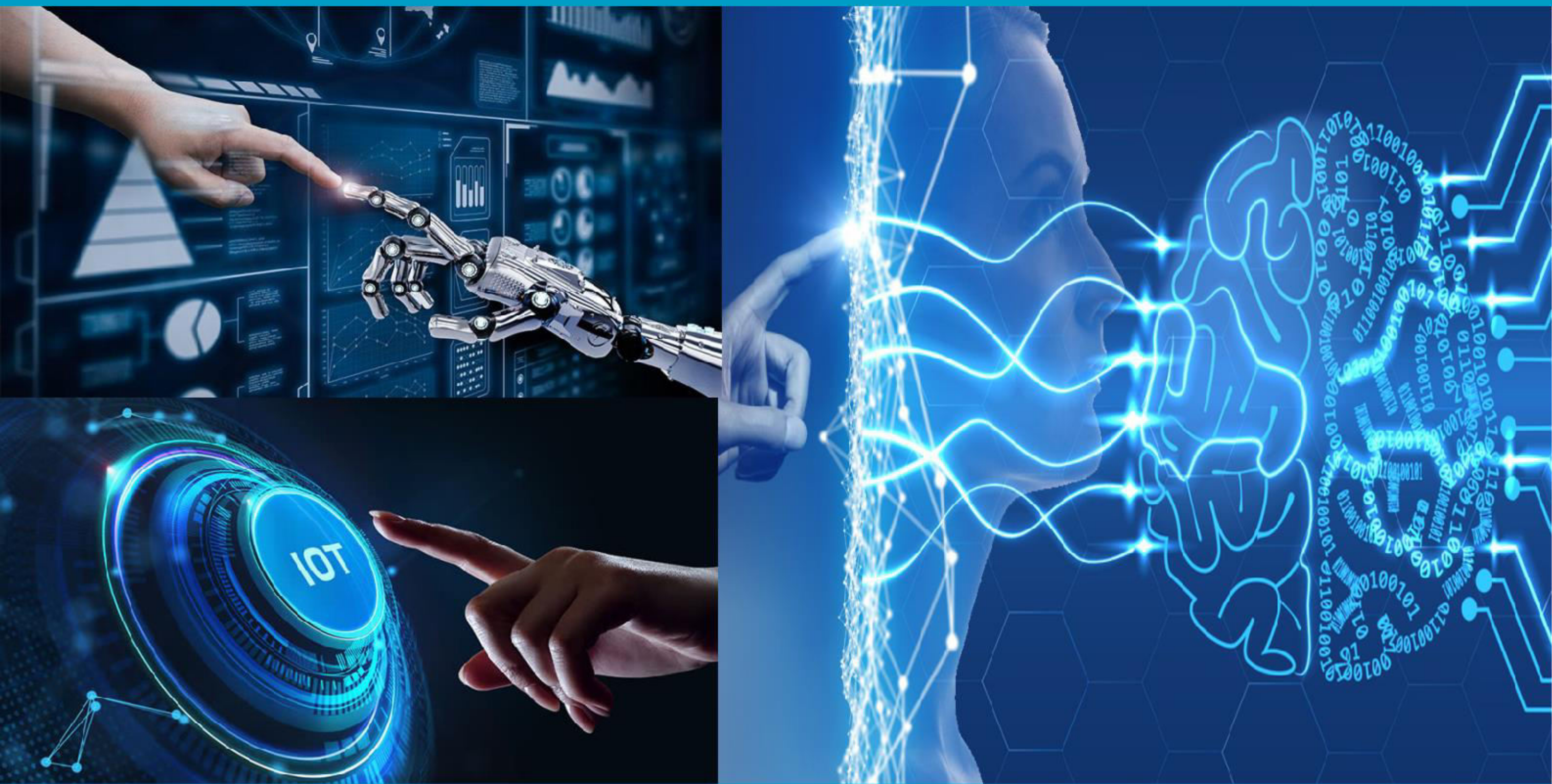

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+91 99405 72462 +9163819 07438 ijmrsetm@gmail.com www.ijmrsetm.com

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Influence of IFRS 16 on Economic Conditions of Indian Companies

Ms. Renu Bala Sharma

Assistant Professor, Dept. of Economic Administration & Financial Management, S.S. Jain Subodh Girls P.G. College, Sanganer, Jaipur, India

ABSTRACT: IFRS 16 is an International Financial Reporting Standard (IFRS) promulgated by the International Accounting Standards Board (IASB) providing guidance on accounting for leases. IFRS 16 was issued in January 2016 and is effective for most companies that report under IFRS since 1 January 2019. IFRS 16 has a substantial impact on the financial statements of lessees of property and equipment – requiring that leases be placed on-balance sheet by recognising a 'right-of-use' asset and a lease liability. The objective of IFRS 16 is to report information that (a) faithfully represents lease transactions and (b) provides a basis for users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. To meet that objective, a lessee should recognise assets and liabilities arising from a lease.IFRS 16 introduces a single lessee accounting model 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. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

KEYWORDS: IFRS 16, financial, accounting, payments, lease, property, cash, India, asset, value

I. INTRODUCTION

In April 2001 the International Accounting Standards Board (Board) adopted IAS 17 Leases, which had originally been issued by the International Accounting Standards Committee (IASC) in December 1997. IAS 17 Leases replaced IAS 17 Accounting for Leases that was issued in September 1982.[1,2]

In April 2001 the Board adopted SIC-15 Operating Leases—Incentives, which had originally been issued by the Standing Interpretations Committee of the IASC in December 1998.

In December 2001 the Board issued SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease. SIC-27 had originally been developed by the Standing Interpretations Committee of the IASC to provide guidance on determining, amongst other things, whether an arrangement that involves the legal form of a lease meets the definition of a lease under IAS 17.

In December 2003 the Board issued a revised IAS 17 as part of its initial agenda of technical projects.

In December 2004 the Board issued IFRIC 4 Determining whether an Arrangement contains a Lease. The Interpretation was developed by the Interpretations Committee to provide guidance on determining whether transactions that do not take the legal form of a lease but convey the right to use an asset in return for a payment or series of payments are, or contain, leases that should be accounted for in accordance with IAS 17.[3,4]

In January 2016 the Board issued IFRS 16 Leases. IFRS 16 replaces IAS 17, IFRIC 4, SIC-15 and SIC-27. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases.

In May 2020 the Board issued Covid-19-Related Rent Concessions, which amended IFRS 16. The amendment permits lessees, as a practical expedient, not to assess whether rent concessions that occur as a direct consequence of the covid-19 pandemic and meet specified conditions are lease modifications. Instead, the lessee accounts for those rent concessions as if they were not lease modifications.

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In August 2020 the Board issued Interest Rate Benchmark Reform—Phase 2 which amended requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 relating to:

- changes in the basis for determining contractual cash flows of financial assets, financial liabilities and lease liabilities;
- hedge accounting; and
- disclosures.

The Phase 2 amendments apply only to changes required by the interest rate benchmark reform to financial instruments and hedging relationships.

Other Standards have made minor consequential amendments to IFRS 16, including Amendments to References to the Conceptual Framework in IFRS Standards (issued March 2018).[5,6]

IFRS 16 Leases applies to all leases, including subleases, except for: [IFRS 16:3] leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; leases of biological assets held by a lessee (see IAS 41 Agriculture); service concession arrangements (see IFRIC 12 Service Concession Arrangements); licences of intellectual property granted by a lessor (see IFRS 15 Revenue from Contracts with Customers); and rights held by a lessee under licensing agreements for items such as films, videos, plays, manuscripts, patents and copyrights within the scope of IAS 38 Intangible Assets

II. DISCUSSION

Identifying a lease

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [IFRS 16:9]Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use. [IFRS 16:B9]An asset is typically identified by being explicitly specified in a contract, but an asset can also be identified by being implicitly specified at the time it is made available for use by the customer.However, where a supplier has a substantive right of substitution throughout the period of use, a customer does not have a right to use an identified asset. [7,8] A supplier's right of substitution is only considered substantive if the supplier has both the practical ability to substitute alternative assets throughout the period of use and they would economically benefit from substitution. [IFRS 16:B13-14]A capacity portion of an asset is still an identified asset if it is physically distinct (e.g. a floor of a building). A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all the capacity such that the customer obtains substantially all the economic benefits from using the asset. [IFRS 16:B20]

Separating components of a contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees shall allocate the consideration payable on the basis of the relative stand-alone prices, which shall be estimated if observable prices are not readily available.As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components and instead account for all components as a lease. [IFRS 16:13-15]Lessors shall allocate consideration in accordance with IFRS 15 Revenue from Contracts with Customers.

Interest rate implicit in the lease

The interest rate that yields a present value of (a) the lease payments and (b) the unguaranteed residual value equal to the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

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Lease term

The non-cancellable period for which a lessee has the right to use an underlying asset, plus:

a) periods covered by an extension option if exercise of that option by the lessee is reasonably certain; and b) periods covered by a termination option if the lessee is reasonably certain not to exercise that option

Lessee's incremental borrowing rate -The rate of interest that a lessee 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 right-of-use asset in a similar economic environment. Upon lease commencement a lessee recognises a right-of-use asset and a lease liability. [IFRS 16:22]The right-of-use asset is initially measured at the amount of the lease liability plus any initial direct costs incurred by the lessee. Adjustments may also be required for lease incentives, payments at or prior to commencement and restoration obligations or similar. [IFRS 16:24]After lease commencement, a lessee shall measure the right-of-use asset using a cost model, unless: [IFRS 16:29, 34, 35]

i) the right-of-use asset is an investment property and the lessee fair values its investment property under IAS 40; or ii) the right-of-use asset relates to a class of PPE to which the lessee applies IAS 16's revaluation model, in which case all right-of-use assets relating to that class of PPE can be revalued.Under the cost model a right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment. [IFRS 16:30(a)]The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. If that rate cannot be readily determined, the lessee shall use their incremental borrowing rate. [IFRS 16:26]Variable lease payments that depend on an index or a rate are included in the initial measurement of the lease liability and are initially measured using the index or rate as at the commencement date. Amounts expected to be payable by the lessee under residual value guarantees are also included. [IFRS 16:27(b),(c)]Variable lease payments that are not included in the measurement of the lease liability are recognised in profit or loss in the period in which the event or condition that triggers payment occurs, unless the costs are included in the carrying amount of another asset under another Standard. [IFRS 16:38(b)The lease liability is subsequently remeasured to reflect changes in: [IFRS 16:36]the lease term (using a revised discount rate); the assessment of a purchase option (using a revised discount rate); the amounts expected to be payable under residual value guarantees (using an unchanged discount rate); or future lease payments resulting from a change in an index or a rate used to determine those payments (using an unchanged discount rate).The remeasurements are treated as adjustments to the right-of-use asset. [IFRS 16:39]

Lease modifications may also prompt remeasurement of the lease liability unless they are to be treated as separate leases. [IFRS 16:36(c)]

Covid-19-related rent concessions

A lessee may elect not to assess whether a COVID-19-related rent concession is a lease modification. A lessee that that applies the exemption accounts for COVID-19-related rent concessions as if they were not lease modifications. [IFRS 16:46A, 46B]

IBOR reform

A lessee accounts for modifications required by the IBOR reform (modifications required as a direct consequence of the IBOR reform and made on an economically equivalent basis) by updating the effective interest rate. All other modifications are accounted for using the applicable requirements. [IFRS 16:105-106]

Accounting by lessors-Lessors shall classify each lease as an operating lease or a finance lease. [IFRS 16:61]A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an

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underlying asset. Otherwise a lease is classified as an operating lease. [IFRS 16:62]Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are: [IFRS 16:63]the lease transfers ownership of the asset to the lessee by the end of the lease term the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised the lease term is for the major part of the economic life of the asset, even if title is not transferred at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset the leased assets are of a specialised nature such that only the lessee can use them without major modifications being madeUpon lease commencement, a lessor shall recognise assets held under a finance lease as a receivable at an amount equal to the net investment in the lease. [IFRS 16:67]A lessor recognises finance income over the lease term of a finance lease, based on a pattern reflecting a constant periodic rate of return on the net investment. [IFRS 16:75]At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which IFRS 15 applies. [IFRS 16:71c)]A lessor recognises operating lease payments as income on a straight-line basis or, if more representative of the pattern in which benefit from use of the underlying asset is diminished, another systematic basis. [IFRS 16:81][9]

Sale and leaseback transactions-To determine whether the transfer of an asset is accounted for as a sale an entity applies the requirements of IFRS 15 for determining when a performance obligation is satisfied. [IFRS 16:99]If an asset transfer satisfies IFRS 15's requirements to be accounted for as a sale the seller measures the right-of-use asset at the proportion of the previous carrying amount that relates to the right of use retained. Accordingly, the seller only recognises the amount of gain or loss that relates to the rights transferred to the buyer. [IFRS 16:100a)]If the fair value of the sale consideration does not equal the asset's fair value, or if the lease payments are not market rates, the sales proceeds are adjusted to fair value, either by accounting for prepayments or additional financing. [IFRS 16:101]A seller-lessee subsequently measures lease liabilities arising from a leaseback in a way that it does not recognise any amount of the gain or loss that relates to the right of use it retains. [IFRS 16:102A]

Disclosure-The objective of IFRS 16's disclosures is for information to be provided in the notes that, together with information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users to assess the effect that leases have. Paragraphs 52 to 60 of IFRS 16 set out detailed requirements for lessees to meet this objective and paragraphs 90 to 97 set out the detailed requirements for lessors. [IFRS 16:51, 89]

Effective date and transition-An entity applies IFRS 16 for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted if IFRS 15 Revenue from Contracts with Customers has also been applied. [IFRS 16:C1]As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. [IFRS 16:C3]A lessee shall either apply IFRS 16 with full retrospective effect or alternatively not restate comparative information but recognise the cumulative effect of initially applying IFRS 16 as an adjustment to opening equity at the date of initial application. [IFRS 16:C5, C7]

III. RESULTS

Aiming to bring more transparency to leases in companies' financial statements, the new standard will not only impact finance and accounting but will also result in major changes in data processing and related processes. Lessors are likely to be least affected by the changes. IFRS 16 Leases is very similar to IAS 17 Leases, introducing changes for subleases, lease modifications and disclosures only. Lessees, on the other hand, are likely to be the most affected, especially those that currently finance significant parts of their activities through operating leases. Accounting for contracts such as operating leases will no longer be applicable, except for short-term leases (terms of 12 months or less) and low-value asset leases. All other leases within the scope of IFRS 16 are required to be brought on-balance sheet by the lessees recognizing the 'right-of-use' of the asset and the related lease liability at commencement of the lease. Subsequent accounting will generally be similar to the finance lease model under IAS 17. With respect to the financial impact,[10] the new standard will firstly affect the balance sheet; it will lead to an increase in assets that are capitalized as well as in loans that are booked as liabilities. Secondly, it will affect the income statement, as lease expenses will be replaced by higher depreciation charges and an interest expense.

Entities will face the following challenges in implementing the new standard:

- Initial analysis of all contracts in order to establish how much and what type of data will have to be processed.
- Making new estimates depending on the nature and term of a lease, which could affect the reliability of financial forecasts.
- Initial recognition and classification: recognition of the lease liability and a right-of-use asset at the commencement date using the present value of the lease payments that are not paid at that date.
- Subsequent measurement and re-measurement: calculation of increase of carrying amount by interest component, increase / decrease by re-measurement component, etc.
- Identification of lease modifications: depending on the criteria met, accounting of lease modification as a separate lease, derecognition and recognition of a new lease or change in the carrying amount of an existing lease contract.
- Disclosures preparation.
- Comparative balance preparation. IFRS 16 provides two options for comparative balance preparation:

Comparatives – Option 1

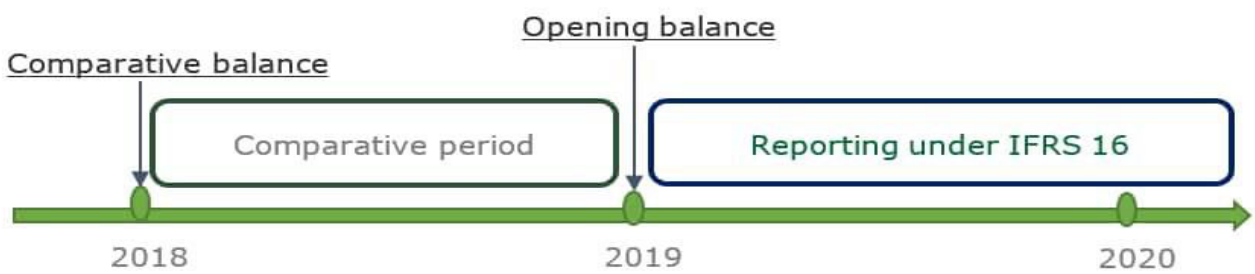
Retrospective: Comparatives are re-calculated under the assumption that IFRS 16 has always been applied since the first day of the operating lease.

Comparatives – Option 2

Cumulative catch-up: Comparatives are presented as previously reported under IAS 17 with the difference in assets to liabilities recognised in operating retained earnings.

- Challenges for information systems and data management. The IFRS 16 standard by its very nature obliges companies to apply greater discipline in the management of leases and processing of data resulting from the contracts in their information systems.

Timeline and comparative balance options for IFRS 16



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IV. IMPLICATIONS

Indian corporations, like their counterparts around the world, are working to ensure compliance with Ind AS 116 - the local equivalent of the IFRS 16 accounting rule - which is mandated by the Ministry of Corporate Affairs and came into effect in April 2019. In examining the likely impact of the standard, the country's vibrant but highly fragmented retail sector stands out. In India, the burden of complying with the new rule is likely to fall inordinately on companies in the country's sprawling retail sector, which is highly dependent on rental properties. According to some estimates, the global retail industry will see a 98% median increase in debt from capitalising leases as required by IFRS 16. The top 10 major retailers in India operate thousands of stores while across India there are hundreds of smaller companies operating, at a conservative estimate, about 25 stores each. This means lease portfolios tend to be very large and geographically spread out, with agreements localised to suit state-specific laws.

Given this diversity, which is further complicated by varying lease payment schedules, one of the key challenges Indian retailers face is data-gathering. For instance, a retail company with its headquarters and centralised accounting operations in Mumbai, will have to deal with consolidating information on all the operating leases entered into by its local offices around the country.[11]

This can be a significant undertaking given that most retailers have historically relied on accounting systems, processes and controls run on basic spreadsheet software - with the possible exception of the largest operators, who may have in-house enterprise resource planning (ERP) software and the capability to customise systems to accommodate the new lease accounting standard.

Recognising the limitations of their systems, small players have now begun to work with software developers – many of whom have sprung to life to serve this very need – to help them build accounting programmes that can handle the IFRS 16 standard. This is a positive development as it will equip these companies to gather, assess and manage data in a more systematic way, and make accounting decisions required by the new standard that will have a bearing not only on the companies' books, but also possibly help enhance visibility on their overall operations.

Once a company's accounting department has access to the consolidated lease information, the next challenge is for the systems to account for the changes in the treatment of leases. With IFRS 16 requiring that most leases, with few exceptions, be shown on company balance sheets, one primary issue concerns whether to account for a lease payment as a separate lease component or not.

A lessee might elect to apply the practical expedient of accounting - one of many available to make the transition to the new rule easier - for a lease and the associated non-lease component, treating it as a single lease component. If the practical expedient is applied, the cash flows associated with the non-lease component will increase the liability and right-of-use asset recognised on the balance sheet.

This is determined by asset class and companies are likely to consider the significance of the increase in relation to the effort and complexity of obtaining the necessary information to separately account for the lease and non-lease components. Retail and consumer lessees with material leases will need additional processes, controls and documentation to ensure appropriate and consistent application of the guidance. For example, the guidance requires an appropriate allocation based on relative stand-alone prices that maximises the use of observable prices.

This is crucial because while earlier both lease and non-lease components would be routed through the profit & loss (P&L) account as a single operating expense, the new standard provides an option to segregate assets from lease components. As a result, combining both will result in higher capitalisation of the asset and higher earnings before interest, tax, depreciation and amortization (EBITDA). But, at the same time, it will result in a higher lease liability on the balance sheet.

Companies also have to assess whether their accounting systems can handle the separation of variable payments that are not linked to a rate or index, and treat them as expenses through the P&L account. In contrast, the earlier accounting standard did not require such a separation.

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Complications can also arise in determining the nature or existence of a lease in certain transactions where the original lessee sublets a property to another lessee, or the rented property is relocated and the original rental contract does not specify a physical location for the outlet - as with a portable stall or kiosk, for example.

Terminal leases also need to be differentiated from those carrying an option to renew under the new standard. While the old system did not treat such leases separately, a lessee now has to decide on a lease term in advance and whether to exercise an option to extend the lease in the future, as this will determine the present value of future lease payments and also how the asset is valued.

These issues highlight the accounting judgments involved in adhering to the new standard, as well as the potential long-term impacts these judgments may have on the overall business. This makes it all the more crucial that bookkeeping decisions are made based on comprehensive knowledge of Ind AS 116, and full awareness of its various strategic and operational implications.

V. CONCLUSIONS

Whether you need help with statutory bookkeeping, consolidated account preparation or international management reporting, we can manage your accounting processes across any jurisdiction without any conflict of interest. On IFRS 16, here to help you with the following[12].

1. **Transition assessment and compliance**: our global team of in-house experts can assess your current and past reporting for IFRS 16 compliance and offer direct and indirect tax compliance support in liaison with relevant authorities for registration, returns, calculations and recovery.
2. **Accounting and reporting**: we can help maintain your books and records in accordance with IFRS 16 accounting standards in multicurrency formats and meeting relevant accounting policies used for management reports (including IFRS 16, local GAAP).

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