A study on the impact of lease capitalisation

Ind AS 116: The new leases standard (proposed)

March 2019

pwc

Table of contents

1. Overview

We conducted a study to assess the impact of the proposed new standard, Ind AS 116 – **Leases** on the financial statements, key financial ratios and performance measures of companies listed on the National Stock Exchange (NSE) of India and included in NIFTY 50 and NIFTY NEXT 50 benchmark indices, excluding companies in the financial services sector.

The study identifies the potential high-level impact of capitalising the operating lease commitments as disclosed in the latest available annual reports of these companies.[1] The proposed effective date as per the Exposure Draft of Ind AS 116 is 1 April 2019. In view of companies' assessment of the lease term under the new standard, the inclusion of amongst others in-substance fixed payments and variable payments linked to an index or rate, the eventual impact may be much greater. Further, the study does not take into account transitional reliefs that are available upon adoption of the new leases standard. We hope you find this publication informative and that it helps us remain connected with you in a meaningful way.

For a variety of additional resources offering more in-depth perspectives on the impact and other aspects of Ind AS, please visit our website at www.pwc.in.

Highlights of the study include:

The average increase in debt would be around **7%.**

The average increase in EBITDA would be around **3%.**

The average debt to equity ratio increases from **0.49** to **0.54**, an increase of around **10%.**

The range of impact is wide, with an increase in debt of at atleast **25%** for **32%** of the companies.

The average increase in finance costs would be around **8%.**

The impact of the new standard differs significantly between industries. The industries that are likely to experience the most significant impact on reported financial ratios and performance measures are:

Technology **Aviation** **Telecom**

Oil and gas **Retail and consumer**

Analysts, banks and some rating agencies generally use a 'rule-of-thumb' to adjust the financial statements for the effects of off-balance sheet operating leases. Many may also use an industry-specific multiple of rent expense rather than the disclosed operating lease commitments in financial statements. The multiple approach using the 'rule-of-thumb' generally results in more significant adjustments to the financial statements.

1. Latest available financial reports were 31 March 2018 or 31 December 2017 for calendar year-end companies.

2. The scope of the new leases standard

The Institute of Chartered Accountants of India (ICAI) has issued an Exposure Draft on Ind AS 116, 'Leases'. Ind AS 116 is largely converged with IFRS 16, Leases issued by the International Accounting Standards Board (IASB). It is proposed to be effective for annual periods beginning on or after 1 April 2019 subject to notification by the Ministry of Corporate Affairs of India. The new standard requires lessees to recognise nearly all leases on their balance sheets which will reflect their right to use an asset for a period of time and the associated liability for payments.

Leasing is an important and widely used financing solution. It is a flexible solution that allows companies to access and use property, plant and equipment without needing to incur large cash outflows. It also enables lessees to address the issue of obsolescence and residual value risk. In fact, sometimes leasing is the only way to obtain the use of a physical asset that is not available for purchase.

Under existing rules, lessees account for lease transactions either as operating or finance leases, depending on complex rules and tests which, in practice, use 'bright-lines' resulting in all or nothing being recognised on balance sheet for sometimes economically similar lease transactions. Under the new leases standard, lessees are required to recognise nearly all leases on the balance sheet which will reflect their right to use an asset for a period of time and the associated liability for payments. All lease liabilities are to be measured with reference to an estimate of the lease term, which includes optional lease periods when an entity is reasonably certain to exercise an option to extend (or not to terminate) a lease.

Lessees

Lessees are expected to be greatly affected by the new standard. The impact on their financial reporting, asset financing, contract and data management, IT systems, and processes and controls is expected to be substantial. Many companies lease a vast number of small and/or big-ticket items, including IT and other equipment, cars, buildings, power plants, retail stores, cell towers and aircraft.

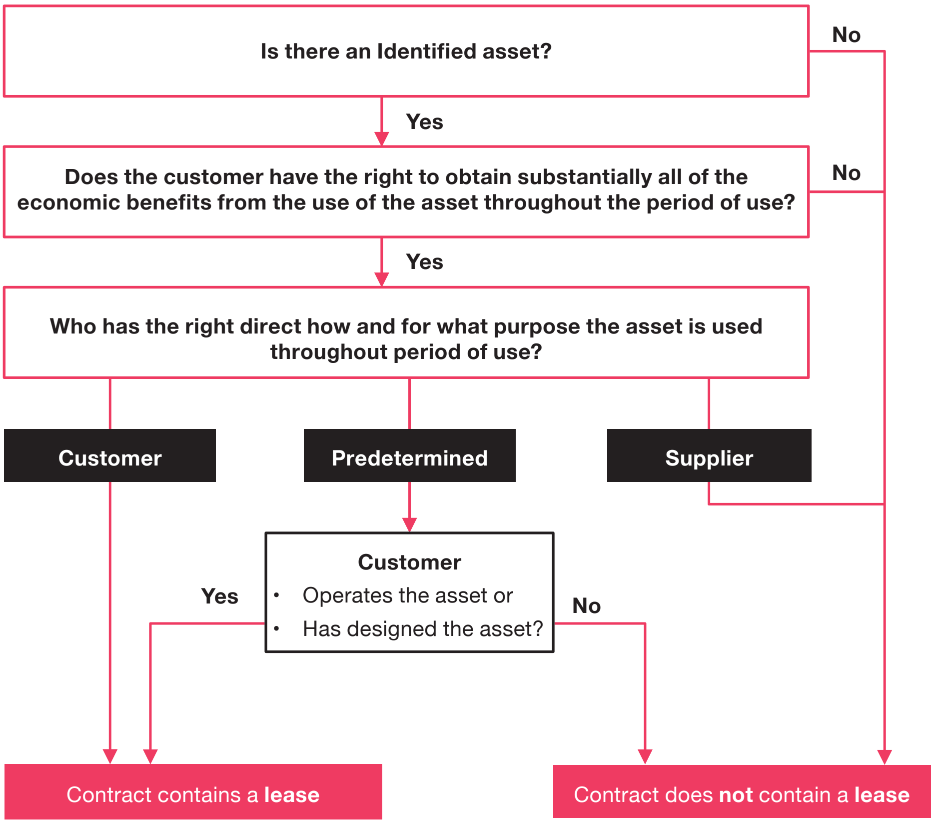
Lessors

The accounting for lessors largely remains unchanged. However, their business models and lease products might be impacted due to changes in the needs and behaviour of their customers (i.e. lessees).

Scope

The scope of Ind AS 116 is generally similar to the existing Ind AS 17 and includes all contracts that convey the right to use an asset for a period of time in exchange for consideration, except for licences of intellectual property granted by a lessor, rights held by a lessee under licensing agreements (such as motion picture films, video recordings, plays, manuscripts, patents and copyrights), leases of biological assets, service concession arrangements and leases to explore for or use minerals, oil, natural gas and similar non regenerative resources. There is an optional scope exemption for lessees of intangible assets other than the licences mentioned above.

The flow chart below summarises the analysis to be made to evaluate whether a contract contains a lease:



However, the definition of a lease is different from the current guidance in Appendix C to Ind AS 17 for evaluating embedded leases and might result in some service or supply contracts being treated differently in the future. Ind AS 116 includes detailed guidance to help companies assess whether a contract contains a lease or a service, or both. Under the current guidance and practice, there is not a lot of emphasis on the distinction between a service and an operating lease, as this often may not change the accounting treatment.

Lease and non-lease components

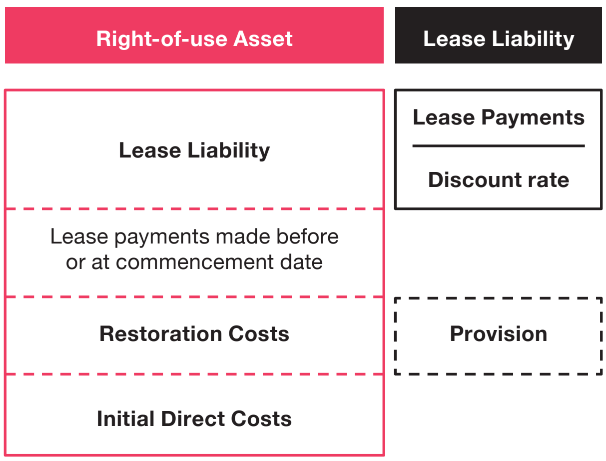
Currently, many arrangements embed an operating lease into the contract or operating lease contracts include non-lease (e.g. service) components. However, entities may not have separated the operating lease component in contracts because the accounting for an operating lease and for a service/supply arrangement generally have a similar impact on the financial statements today. Under the new leases standard, lessee accounting for the two elements of the contract will change because all leases will have to be recognised on the balance sheet.

The new lease model

The distinction between operating and finance leases is eliminated for lessees, and a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) are recognised for all leases. When certain criteria are met there are optional exemptions available for short term leases (lease terms shorter than 12 months) and leases of low value assets. These leases do not have to be recognised on the balance sheet but can be accounted for similar to an operating lease in accordance with Ind AS 17 today and remain off the balance sheet.

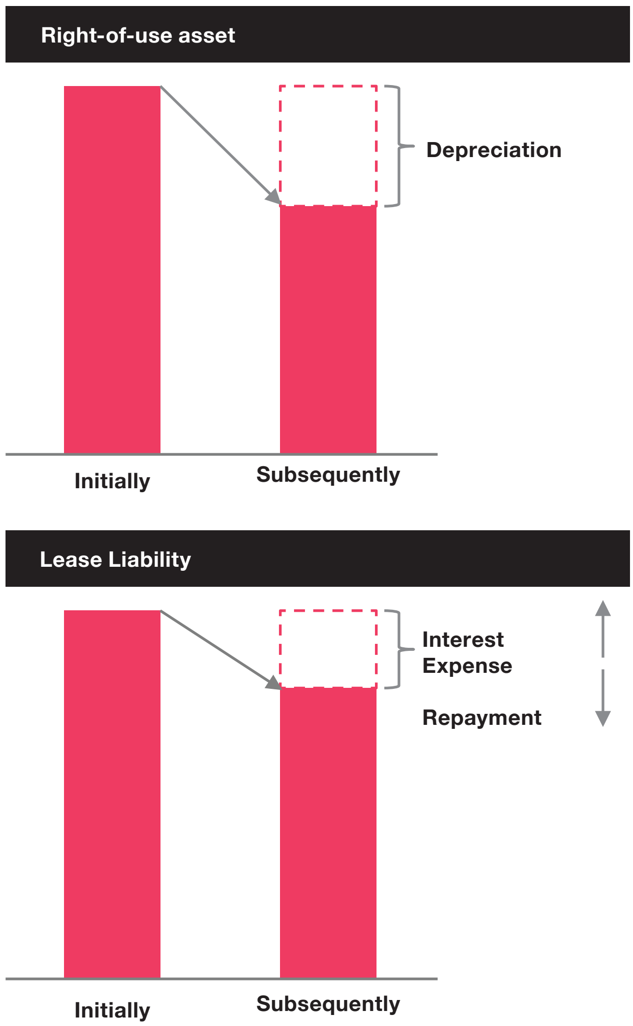
At the outset, lessees should recognise a right-of-use asset and lease liability based on the discounted payments required under the lease, taking into account the lease term as determined under the new standard. Initial direct costs and restoration costs are also included in the right-of-use asset.

The diagram below summarises the initial measurement of a right-of-use asset and a lease liability:



Lease liability is measured in subsequent periods using the effective interest rate method. The right-of-use asset is depreciated in accordance with the requirements in Ind AS 16, **'Property, plant and equipment'** which will result in depreciation on a straight-line basis or another systematic basis that is more representative of the pattern in which the entity expects to consume the right-of-use asset. The lessee must also apply the impairment requirements in Ind AS 36, **'Impairment of assets'** to the right-of-use asset.

The carrying amount of the right-of-use asset and the lease liability will no longer be equal in subsequent periods. Due to the 'frontloading' effect described below, the carrying amount of the right-of-use asset will, in general, be below the carrying amount of the lease liability. The chart below summarises the subsequent measurement of a right-of-use asset and a lease liability:



Lessor accounting does not change and lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements or sales, the balance sheet reflects a lease receivable and the lessor's residual interest, if any.

3. Impact of the new standard

Our study has quantified the potential high-level impact of the proposed new leases standard on financial ratios and performance measures reported by the companies selected for our study. The main impact of the changes to lease accounting is that the reported debt and EBITDA will increase; for certain entities and industries that increase will be substantial.

3.1. Sector-wise impact

Technology

- When it comes to leasing transactions, many entities in the IT industry will be the lessees. The IT industry is likely to be one of the most affected by the new standard, given the significant use of rented premises for their operations. Additional items may include IT and data equipment.
- Such leases have been considered as operating leases in the past, and have not therefore had any impact on the balance sheet. The amount recorded in the income statement was typically on a straight line basis and included in operating expenses.
- Under the new standard, such leases will be recognised in the balance sheet which would significantly increase the leverage of the industry.

Aviation

- The initiative to develop a new leases standard goes back to the time when Sir David Tweedie was the chairman of the IASB. He joked that he wanted to fly in an aircraft that actually existed on an airline's balance sheet.
- For decades, financing aircraft through off-balance sheet lease models has been a well-established practice in the Airline industry. In addition, airport facilities which are essential to run airline operations are typically rented from the respective airport owner.
- Under Ind AS 116, substantially all lease contracts will be on the balance sheet of the lessee. Estimates suggest this change will mean that significant additional lease obligations will be added to the balance sheets of Airlines. Further, as many lease obligations are denominated in foreign currency e.g. US-Dollar, airlines will also be exposed to additional foreign currency volatility into their profit or loss.
- The accounting for sale and leaseback transactions depends on whether the transfer of the asset qualifies as a sale in accordance with Ind AS 115, '**Revenue from Contracts with Customers'**. The potential seller-lessee applies the requirements for determining when a performance obligation is satisfied in accordance with Ind AS 115. This could result in a lower recognition of gains on sale and leaseback transactions.

Telecom

- Most telecom companies enter into lease agreements both as lessors and lessees. The new standard is therefore likely to have a material impact for these companies. Typical areas where the standard will have a significant impact are
  - arrangements with other operators;
  - shared network assets arrangements;
  - arrangements where network equipment is embedded in the supply of communication services; and
  - leases of network sites and retail space.
- In respect of leases embedded within service arrangements, the application of Appendix C of Ind AS 17 has historically been a judgmental area in the industry. Ind AS 116 brings in new conditions to be assessed in the determination of whether the agreement contains a lease which may impact current industry custom and practice.

Retail and consumer

- The retail industry is likely to be one of the most affected by the new standard, given the significant use of rented premises for their stores.
- Most of such leases are in the form of leases for premises, retail outlets and IT equipment. Leases of premises and retail outlets typically offer renewal options, and often involve variable rentals. This variability is commonly due to inflation adjustments and contingent rentals in some locations where the property owner has a vested interest in the performance of the business.
- Historically, such leases have been considered as operating leases, and have not therefore had any impact on the balance sheet. The amount recorded in the income statement was typically on a straight line basis and included in operating expenses. The new lease standard will not only have an impact on the balance sheet, but also on the operating costs, with a split of the expense between operating and finance costs.

Oil and gas

- Energy companies will need to establish a process to identify and assess all potential lease arrangements, including drilling and transportation contracts.
- Given the capital-intensive nature of the industry, and the fact that highly specialised equipment is not always owned, the new leasing standard will have a significant impact on many energy companies. The application of guidance on variable rents, separating lease components from non-lease components, and interaction with existing standards for oil and gas producing activities are some of the key challenges preparers will face.
- Current lease accounting guidance does not address whether non-distinguishable portions of an asset, such as capacity in a pipeline or a storage tank, can be the subject of a lease.
- Since under the new standard, all leases will be recognised on the balance sheet, the determination as to whether a contract is or contains a lease will be much more important.

Automotive

- A thorough understanding of a tooling arrangement from a commercial and economic perspective will be required to determine whether or not such arrangement contains an embedded lease.
- Since the tooling is generally so specific to the vehicle manufacturer, it would be common for the parts supplier to have some kind of payment protection, either in the form of a “take or pay” arrangement or other economic penalty in case the vehicle manufacturer decides to reduce the specific vehicle production. Similarly, it would be uncommon that the vehicle manufacturer would not have a mechanism to protect against production stoppages or have other economic penalty in case the parts supplier is not able to deliver the parts in the required volumes.
- Therefore, one would need to understand the commercial basis for the arrangement before concluding on whether or not the vehicle manufacturer controls the use of the tooling.
- Similar analysis may also be required for auto component supply contracts.

Pharma

- Leases are used in the Pharmaceutical industry in a variety of ways. Pharma companies typically lease buildings, company cars and computers, many of which are currently accounted for as operating leases. Similar to automotive companies, pharma companies may also have embedded leases in their tolling or supply contracts.

Key areas where Ind AS 116 will have the most impact

Ind AS 116 - Right of use asset and liability		
Definition of lease and lease term	Short-term leases and low value assets	Variable lease payments
Lease modifications	Sale and leaseback transactions	Presentation and disclosures

3.2. Financial, operational and business impacts

Financial information

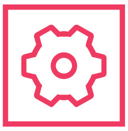
- The new standard will gross up balance sheets and change income statement and cash flow presentation. Rent expense will be replaced by depreciation and interest expense in the income statement (similar to finance leases today). This results in a front-loaded lease expense, which for some might decrease earnings and equity immediately after entering into a lease compared to an operating lease today.

Financial ratios and performance metrics redefined

- Most commonly used financial ratios and performance metrics will be impacted, such as gearing, current ratio, asset turnover, interest cover, EBIT, operating profit, net income, EPS, ROCE, ROE, and operating cash flows. However, some performance measures such as operating profit, EBIT, EBITDA and operating cash flows reported would improve, with no change in the underlying cash flows or business activity.
- The effect on financial ratios (such as gearing or leverage) may trigger breaches of loan covenants. An increase of interest expenses might also trigger covenants based on interest. Additionally, these changes may also affect credit ratings. Entities should also check whether they have agreed on ‘frozen’ GAAP clauses or need to agree amendments to covenants in their existing and future financing arrangements to avoid surprises. Lastly, entities need to consider the effect of these changes to their remuneration schemes and staff bonuses. Entities often operate in a complex environment, and these redefined metrics will affect many existing arrangements and stakeholders.
- Entities anticipating capital market transactions shortly before or after the effective date of the new leases standard should consider the effects on their leverage/ gearing ratios, how this benchmarks with peers and consider any specific regulatory requirements to present historical financial information and track record.

Stakeholder awareness and communication

- We anticipate that internal and external stakeholders will want to understand the impact of the new leases standard on various financial metrics. Timely assessment of which arrangements and stakeholders are affected by these redefined financial ratios and metrics will enable an entity to proactively revise its arrangements if needed and engage its stakeholders.



Implementation can be cumbersome and time consuming

- An entity should carefully assess the effects at an early stage, perform an inventory of contracts involved, understand the impact of the new standard and develop an early communication strategy with its stakeholders. This includes extracting, gathering and validating lease data, assessing the impact and preparing for any re-design of its IT systems or implementation of new IT systems and processes impacted by the new standard.
- Lease data requirements will increase given that operating leases have historically been off-balance sheet. In addition, increased disclosure requirements for leases will also require additional data collection. Extracting lease data from lease contracts that currently is not systematised, and/or collecting lease data from different operational or other 'systems', may prove difficult and time-consuming. Once data is gathered and migrated from various sources it will need to be validated, standardised and analysed. The practical implications in gathering, validating and standardising lease data across the group can be time-consuming – for example, consider foreign locations and their lease data which may require language translations. Then, cataloging existing leases, identifying lease data gaps and ensuring completeness can be a major effort. This may also require significant resources and supporting (automated) lease extraction, validation and analysis tools during the implementation process.
- It is important to remember that companies will not only need to inventorise and summarise their existing traditional lease contracts, but also evaluate their supply and service arrangements to identify and account for any potential embedded leases.

3.3. Summary of study results

The study has quantified a high level potential impact of the proposed new leases standard on financial ratios and performance measures reported by Ind AS reporters, except for financial services companies. Based on the operating lease commitment disclosures in the latest annual reports (consolidated except where not applicable) of the 78 companies listed on NSE, it is expected that the reported debt of these entities will increase with an average of approximately 7%. Approximately one-third of the entities will see an increase in their debt of atleast 25%.

The study also shows that the impact on financial ratios differs significantly by industry. Industries that are expected to see the largest impact on reported financial ratios and performance measures are:

- Technology
- Aviation
- Telecom
- Oil and gas
- Retail and consumer

The analysis also indicates that the overall average debt to equity ratio is expected to increase by 10% because financial liabilities increase (and equity is expected to decrease). A consequential impact is on the average finance costs which are expected to increase by approximately 8%.

There are significant differences in the effects of lease capitalisation by industry and also between individual entities within the same industry.

The tables on the next pages include a summary of the impact by industry. Certain entities have limited debt balances/low leverage. As a consequence the impact of capitalisation of operating lease commitments is relatively high on the average changes for financial ratios. Therefore, the industry-wise impact may differ significantly on account of the presence of companies with a low/nil debt base within the respective industry.

Impact on debt

Industry	Min. change in debt	Max. change in debt	Average change in debt	% of entities with more than 25% increase
Automotive	0%	100%	3%	30%
Aviation	321%	321%	321%	100%
Industrial manufacturing	0%	248%	1%	27%
Metals	0%	100%	1%	14%
Oil and gas	0%	345%	8%	13%
Pharmaceuticals, life sciences and healthcare	0%	5%	1%	0%
Power and mining	0%	0%	0%	0%
Retail and consumer	0%	130%	8%	43%
Technology	12%	1532%	55%	67%
Telecom	27%	100%	30%	100%
Others	1%	100%	2%	29%

Impact on debt equity ratio

Industry	Average debt equity ratio before Ind AS 116	Average debt equity ratio after Ind AS 116	Average increase in debt equity ratio
Automotive	0.52	0.54	2%
Aviation	0.35	1.46	321%
Industrial manufacturing	0.36	0.36	1%
Metals	0.85	0.86	1%
Oil and gas	0.54	0.63	18%
Pharmaceuticals, life sciences and healthcare	0.59	0.60	1%
Power and mining	1.10	1.10	0%
Retail and consumer	0.19	0.21	7%
Technology	0.07	0.10	46%
Telecom	1.18	1.60	36%
Others	0.44	0.46	2%

Impact on EBITDA

Industry	Min change in EBITDA	Max change in EBITDA	Average increase in EBITDA
Automotive	0%	2%	0.8%
Aviation	50%	50%	50.3%
Industrial manufacturing	0%	1%	0.6%
Metals	0%	2%	0.5%
Oil and gas	0%	15%	3.3%
Pharmaceuticals, life sciences and healthcare	0%	2%	0.7%
Power and mining	0%	0%	0%
Retail and consumer	0%	3%	0.4%
Technology	1%	3%	2.1%
Telecom	11%	33%	22.9%
Others	0%	1%	0.6%

3.4. Study methodology

The study is based on the latest available annual reports of 78 companies listed on the NSE. The approach applied was constructive capitalisation approach which is based on the disclosed operating lease commitments and other information as appearing in the consolidated (standalone where applicable) financial statements of these companies. The entities were grouped into eleven main industries.

The disclosures in the financial statements include the operating lease commitments for minimum lease payments under Ind AS 17 Leases. The operating lease commitments under Ind AS are generally disclosed in a first year lease commitment, lease commitment for years' two to five and lease commitment after five years. On the basis of these disclosures in the financial statements and certain assumptions regarding lease term, etc. an allocation of lease payments was performed to individual years. These annual lease payments were subsequently discounted to calculate the lease liability. The discount rate applied was based on the industry-specific average interest cost obtained from a publicly available research report. The averages calculated are simple averages for all the companies selected for the study. Industry specific averages are simple averages for all the companies in that industry.

The increase in debt is determined using the calculated lease liabilities for off-balance sheet operating leases and their relative impact on debt already on the balance sheets of these entities.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. It is to be noted that in absence of detailed information and due to significant estimation, approximation and assumptions involved, this study has attempted to quantify a high level and indicative potential impact of the proposed new leases standard on financial ratios and performance measures. This information should not be used or relied for any decision-making.

3.5. Next steps

Historically, many lessees have not needed extensive systems and controls for their leases. A process was needed to initially classify a lease as operating or capital, but once it was classified the accounts payable or fixed asset systems generally sufficed.

Under the proposed new standard, the initial balance sheet recording and the subsequent reassessment of lease term, payment estimates and support for management assumptions may require significant changes to existing processes and internal controls. Monitoring and evaluating the estimates and updating and reconciling the balance sheet and income statement balances, including with payments may also require more personnel resources than those needed under current accounting rules.

Prior to adoption, management will need to catalogue existing contracts and gather data about payments, renewal options and the length of the arrangements. Many of these arrangements may be spread across locations and entities including foreign operations.

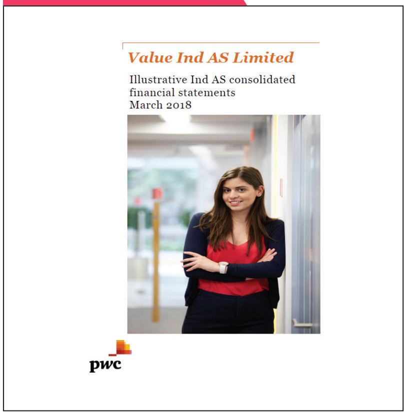
Depending on issues such as the number of leases, the inception dates, and the availability of records, the process of gathering and analysing the information could take considerable time and effort. Other factors that had not been a focus before, such as embedded leases, will also need to be identified and recorded.

Companies may need to invest in new information systems, including ones that capture and catalogue relevant information. Entities should also plan to evaluate their systems and controls to ensure they have the appropriate infrastructure in place prior to the effective date of the new model.

We recommend considering these and other issues now, so organisations will be ready to capture and analyse the information, make the calculations and most importantly start stakeholder communication of the impact of the new standard.

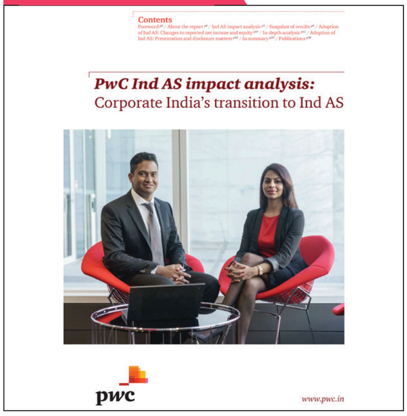
Previous publications

Publications-1



Publications-2

Publications-3



Publications-4

Publications-5

Publications-6

Publications-7

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 158 countries with over 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com

In India, PwC has offices in these cities: Ahmedabad, Bengaluru, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, visit www.pwc.in

PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

© 2019 PwC. All rights reserved

Our offices

Ahmedabad
1701, 17th Floor, Shapath V
Opposite Karnavati Club
S G Highway
Ahmedabad - 380 051
Gujarat
Phone: [91] (79) 3091 7000

Bengaluru
The Millenia, Tower D
#1 & 2 Murphy Road, Ulsoor
Bengaluru - 560 008
Karnataka
Phone: [91] (80) 4079 4000

Chennai
Prestige Palladium Bayan
8th Floor, 129–140, Greams Road
Chennai - 600 006
Tamil Nadu
Phone: [91] (44) 4228 5000

Delhi NCR
Building 8, Tower B
DLF Cyber City
Gurgaon - 122 002
Haryana
Phone: [91] (124) 462 0000

Hyderabad
Plot no. 77/A, 8-624/A/1
3rd Floor, Road no. 10
Banjara Hills
Hyderabad- 500 034
Telangana
Phone: [91] (40) 4424 6000

Kolkata
Plot nos 56 & 57
Block DN-57, Sector V
Salt Lake Electronics Complex
Kolkata - 700 091
West Bengal
Phone: [91] (33) 2357 9100

Mumbai
252 Veer Savarkar Marg
Next to Mayor's Bungalow
Shivaji Park, Dadar
Mumbai - 400 028
Maharashtra
Phone: [91] (22) 6669 1000

Pune
Tower A - Wing 1, 7th Floor
Business Bay
Airport Road, Yerawada
Pune - 411 006
Maharashtra
Phone: [91] (20) 4100 4444

Notes

Notes

pwc.in

Data Classification: DC0

This document does not constitute professional advice. The information in this document has been obtained or derived from sources believed by PricewaterhouseCoopers Private Limited (PwCPL) to be reliable but PwCPL does not represent that this information is accurate or complete. Any opinions or estimates contained in this document represent the judgment of PwCPL at this time and are subject to change without notice. Readers of this publication are advised to seek their own professional advice before taking any course of action or decision, for which they are entirely responsible, based on the contents of this publication. PwCPL neither accepts or assumes any responsibility or liability to any reader of this publication in respect of the information contained within it or for any decisions readers may take or decide not to or fail to take.

© 2019 PricewaterhouseCoopers Private Limited. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers Private Limited (a limited liability company in India having Corporate Identity Number or CIN : U74140WB1983PTC036093), which is a member firm of PricewaterhouseCoopers International Limited (PwCIL), each member firm of which is a separate legal entity.
KS/March2019-16713