

Query No. 28

Subject: Classification of land lease.¹

A. Facts of the Case

1. The Government of Andhra Pradesh (GoAP) vide G.O. Ms No. 39 dated 10.08.2020 of Industries and Commerce (P&I) Department of GoAP introduced the A.P. Industrial Development Policy 2020-23 wherein the GoAP intends to de-risk the businesses by reducing their upfront costs. To this end, the current 'Out Right Sale model' for allotment is replaced with a composite 'Lease cum Buy model' in which land will be given on lease for a period of 33 years, with an option to buy the land after 10 years of successful business operations.

Accordingly, the Allotment Regulations of a Corporation (hereinafter referred to as 'the Corporation') engaged in allotment/leasing of land are modified and the new allotment regulations, 2020 are approved by the Board of Directors which are applicable from December, 2020. As per the industrial policy and the allotment regulations, land will be allotted to the entrepreneurs on lease basis for a period of 33 years.

2. The land will be allotted on lease initially for a period of 33 years with buy-out option at any point of time after 10 years of successful implementation of the project by paying 20% of allotment cost as buy-out premium or extending the lease upto 99 years. The buy-out premium is not applicable for allottees who have paid the entire land cost in lumpsum without availing any instalments and successfully implemented the project within the stipulated time.

3. In addition to the land cost, the allottee has to pay annual lease rentals of Rs. 1,000/- per acre or part thereto subject to a maximum of Rs. 10,000/- per allotment to the Corporation during the period of lease. The payment schedule offered to the entrepreneur/allottee is as follows:

Advance Payment	Lease Term	Additional discount on Allotment Price	Payment of balance Allotment Price	Annual Lease rental
100%	33 years	As per Policy	NIL	Annual Lease Rental calculated as per clause 8.4(b), shall be paid from the date of signing of Lease Deed.
50%	33 years	As per Policy	On completion of the stipulated period for implementation of project or Date of Commercial Production (DCP) whichever is earlier, the balance 50% shall be paid along with 9% interest per annum on the balance amount from the date of	Annual Lease Rental calculated as per clause 8.4(b), shall be paid from the date of signing of Lease Deed.

¹ Opinion finalised by the Committee on 19.1.2022.

			handing over of possession of land	
25% (Only for SC/ST)	33 years	As per Policy	On completion of the stipulated period for implementation of project or DCP whichever is earlier, the balance 75% will be paid in 8 equated annual installments with 8% interest per annum	Annual Lease Rental calculated as per clause 8.4(b), shall be paid from the date of signing of Lease Deed

The Corporation issues No Objection Certificate (NOC) to the financial institution/banks for mortgage of lease rights with first charge. According to the querist, the risks and rewards of ownership of land are transferred to lease holder.

4. The core business of the Corporation is acquiring land for development of industrial parks through the state of A.P. The Corporation acquires land, obtains environmental clearance for industrial parks, prepares layout as per Directorate of Town and Country Planning (DTCP) Rules and regulations with provision of roads, electricity, water supply, storm water drains, common effluent treatment plant (CETP) etc., within the Industrial park and offers plots for setting up of industries on lease basis initially for a period of 33 years with an option of buy-out after 10 years of successful implementation of the project. In case of undeveloped land, the land acquired is offered on lease on “As is where is” basis and no development activity i.e., provision of infrastructure, environmental clearance etc. is undertaken by the Corporation.

The purpose of developing the infrastructure is to facilitate speedy industrialisation of the state of Andhra Pradesh (A.P.) and to offer the entrepreneur all the necessary facilities for setting up of industry so that the entrepreneur need not approach different departments for obtaining layout approvals, encumbrance certificate (EC), electricity, water supply, roads, drains, CETP etc.

5. The Corporation has adopted the accounting policies as per Indian Accounting standards (Ind ASs) from the financial year (F.Y.) 2017-18 and the revenue on execution of sale agreement is being recognised as per the provisions of Ind AS 115, ‘Revenue from Contracts with Customers’. Further, at present the Corporation is allotting lands on lease basis also, which are treated as operating leases and the revenue is being recognised as per Ind AS 116, ‘Leases’.

6. The Corporation allots the land on lease as:

- (a) Land in addition to provision of infrastructure, viz., roads, drains, electricity etc., on the land allotted, i.e., partly lease component and partly non-lease component.
- (b) Undeveloped land, i.e., allotment of land without any provision of infrastructure, i.e., only lease component.

7. The opinion of the Corporation for accounting the lease transactions is as follows:

- (a) Lease to be treated as finance lease since the allottee will pay the upfront cost in advance, risks and rewards are transferred to the allottee, NOC will be issued for mortgage and the lease is also perpetual or buy-out option is exercisable by the allottee.
- (b) Revenue to be recognised in line with paragraphs 73 to 90 of Ind AS I 15.
- (c) The buy-out premium, if any, to be recognised as revenue in the year of revenue itself.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on accounting for land lease in the books of account of the Corporation from the F.Y. 2021-22 on the following aspects:

- (a) Whether the lease is a finance lease/operating lease
- (b) Revenue recognition
- (c) Cost of lease
- (d) Treatment of premium at the time of buy-out option
- (e) Treatment of the inventory of land and infrastructure

C. Points considered by the Committee

9. The Committee notes that the basic issues raised by the querist relate to the lease classification and recognition of revenue and cost in the financial statements of the Corporation. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment by the lessees, applicability of Ind AS to the Corporation, determination of interest rate implicit in the lease, impairment of net investment in lease, etc. Further, the Committee has examined the issue only from Ind AS perspective and has not examined the GST, Income-tax and regulatory or legal aspects.

10. The Committee notes that Ind AS 115, 'Revenue from Contracts with Customers' provides as follows:

- “5 An entity shall apply this Standard to all contracts with customers, except the following:
- (a) lease contracts within the scope of Ind AS 116, *Leases*;
- ...”

The Committee further notes the following requirements of Ind AS 116:

- “9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.**

- 10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).
- 11 An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.”
- “B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:
 - (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21– B23); and
 - (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).”

Appendix A to Ind AS 116 provides the following definition of ‘lease’

“**Lease** A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.”

The Committee notes that in the extant case, the arrangement involves the Corporation conveying the right to use the land parcel to the lessee for a specified period of time, i.e., 33 years, in exchange for consideration. During the course of the lease period, the lessee has the right to substantially all of the economic benefits from use of the land.

The Committee is therefore of the view that the arrangement is in the nature of lease within the scope of Ind AS 116. Therefore, the arrangement is outside the scope of Ind AS 115 for the lease components within the arrangement. The arrangement may, however, contain non-lease elements/components which may be within the scope of Ind AS 115. In this regard, the Committee notes that Ind AS 116, ‘Leases’ provides as follows:

“**Lessee**

- 13 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.
- 14 The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximising the use of observable information.
- 15 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 each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of Ind AS 109, *Financial Instruments*.

- 16 Unless the practical expedient in paragraph 15 is applied, a lessee shall account for non-lease components applying other applicable Standards.

Lessor

- 17 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73–90 of Ind AS 115.”

The Committee notes that as per the facts provided by the querist, the leases consist of:

- Developed land, where in addition to land, the Corporation also provides infrastructure such as, roads, drains, electricity etc., on the land allotted, i.e., partly lease component and partly non-lease component.
- Undeveloped land, i.e., allotment of land without any provision of infrastructure, i.e., only lease component.

The Committee notes that certain leasing arrangements in the extant case contain non-lease components, such as, electricity supply. Under paragraph 17 of Ind AS 116, when a contract that contains a lease component and one or more additional lease or non-lease components, the lessor shall allocate the consideration in the contract applying paragraphs 73–90 of Ind AS 115. The Corporation should accordingly separate the non-lease components unless the practical expedient in paragraph 15 of Ind AS 116, as reproduced above is applied. The non-lease components shall be accounted for as per the requirements of other applicable Standards, such as, Ind AS 115. The lease components shall be accounted for as per the requirements of Ind AS 116.

11. The Committee further notes the following requirements of Ind AS 116:

“61 A lessor shall classify each of its leases as either an *operating lease* or a *finance lease*.

62 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

63 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- (a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the *fair value* at the date the option becomes exercisable for it to be reasonably certain, at the *inception date*, that the option will be exercised;
- (c) the lease term is for the major part of the *economic life* of the underlying asset even if title is not transferred;

- (d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and
 - (e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.
- 64 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
- (a) if the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee;
 - (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and
 - (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
- 65 The examples and indicators in paragraphs 63–64 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease. For example, this may be the case if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards.”

The Committee notes from the above that paragraphs 61-65 of Ind AS 116, provide the criteria for classification of leases into finance or operating lease. As per paragraph 61 of Ind AS 116, at inception date of the lease, a lessor classifies each of its leases as either an operating lease or a finance lease. Therefore, the Corporation should make this classification on an individual lease-by-lease basis and not at general overall level. However, as a practical expedient, the Corporation may apply the requirements of Ind AS 116 to a portfolio of leases with similar characteristics, if it expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. Further, if accounting for a portfolio, the Corporation shall use estimates and assumptions that reflect the size and composition of the portfolio as required by paragraph B1 of Application Guidance to Ind AS 116 as stated below:

“B1 This Standard specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply this Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.”

The Committee also notes that as per the requirements of Ind AS 116, the classification of leases into operating and finance leases is based on the extent to which the lease transfers *substantially all* the risks and rewards incidental to ownership of an underlying asset. Some of the indicators to consider in the overall context of whether there is transfer of substantially all the risks and rewards incidental to ownership include the lessee’s ability to renew lease for another term at substantially below market rent, lessee’s option to purchase at price

significantly below fair value, whether the lease term is for the *major part* of the economic life of the underlying asset, at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset etc. The rewards, in this context, may be represented, inter alia, by the expectation of gain from appreciation in value or realisation of a residual value. The classification of operating or finance lease depends on the substance of the transaction rather than the form of the contract.

12. In the extant case, the Committee notes that the lease deed shared by the querist has the following clauses:

- “7. After implementation of the Project, as per the Detailed Project Report/Project Report and after 10 (Ten) years of continuous successful operation, from the Date of Commercial Production (DCP) and if the LESSEE has paid to the LESSOR , all the dues including any interest, arising out of this LEASE deed, the LESSEE may opt to:
- a. Buy the Scheduled Property, subject to payment of an additional cost of 20% of the Allotment Price, as buy-out premium for the Scheduled Property
(or)
 - b. get extension of the LEASE period i.e. the LEASE period will be extended upto 99 (Ninety Nine) years without any additional amount, on the same terms and conditions of this LEASE Deed. ...”

- “16. a) The LESSEE, may mortgage the schedule property, only after obtaining **No Objection Certificate (NOC)** from the Corporation to avail loan only for construction of factory building and for establishment of plant and machinery for the purpose of the project implementation from reputed financial institutions/scheduled banks. ...”

As per the above terms and conditions of the lease deed, the lessee may take over the land parcel allotted at any time after the first 10 years of continuous successful operation, at 20% premium. Further, as per Allotment regulations, this buy-out premium is not payable, where the lessee has paid the entire land cost in lumpsum without availing any instalments and successfully implemented the project within the stipulated time. Alternatively, the lessee may opt for extending the lease on same conditions without any further payments. The Committee further notes that as per the lease deed, annual lease payments is capped to Rs. 10,000 and therefore not very significant. The lessee may also mortgage the leased property during the lease term.

Further, as per Clause 7.12 of the Allotment Regulations submitted by the querist, the adjusted allotment price will be fixed periodically by the Price Fixation and Infrastructure Committee (PF&IC) of the Corporation. While affixing the adjusted allotment price (which will be offered as final Allotment Price to entrepreneurs), the average of the Local SRO rates and industrial land rates as determined from the revenue departments shall be taken to determine the local average price. Based on this, it seems that the initial allotment price that the lessee has to pay covers at least substantially all of the fair value of the underlying asset.

Further, the lease payments decided at the beginning of the lease are fixed and subject to no changes/escalation irrespective of any change in the value of the asset under lease. Thus, the resultant gain/loss from appreciation or depreciation in the value of the leased land is borne by the lessee, at the time of exercising the buyout option.

The Committee also notes that in the extant case, the risk in the form of idle capacity of the leased asset also apparently vests with the lessee.

13. With regard to the condition that whether the lease term is for the *major part* of the economic life of the underlying asset, the Committee notes that the underlying asset in the extant case is land, which normally has an indefinite economic life. In this context, the Committee notes that paragraph BC 78 to Basis for Conclusions to International Financial Reporting Standard (IFRS) 16 ‘Leases’, issued by the International Accounting Standards Board (IASB) states as follows:

“BC78 A long-term lease of land is sometimes regarded as being economically similar to the purchase of the land. Consequently, some stakeholders suggested that long-term leases of land should be excluded from the scope of IFRS 16. However, the IASB decided not to specifically exclude such leases from the scope of IFRS 16 because:

- (a) there is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.
- (b)”

The Committee also notes that paragraphs B55-B57 of Ind AS 116 states that in determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

Further, the Committee notes that Ind AS 116 does not provide quantitative indicators or thresholds for the assessment of the term ‘substantially all’ to determine that a lease should be classified as a finance lease rather than as an operating lease. Under Ind AS 116, entities apply qualitative, rather than quantitative assessments to determine whether the risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Therefore, assessing whether the present value of the minimum lease payments amounts to at least substantially all of the fair value of a leased asset is a matter of judgement.

Accordingly, the Committee is of the view that an entity or lessor should exercise its judgement considering various factors, as discussed above to determine whether the individual lease is an operating lease or finance lease. If it is clear from various factors/features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease and not finance lease and vice versa.

In the extant case, the Corporation has provided the lessee an option to purchase the land leased, either without any additional cost (in case where the lessee opts to make upfront lease payments) or at 20% of the allotment price (in case where the lessee opts to make lease payments on instalment basis). In the extant case, the exercise price for the option in the lease agreements (which is nil or 20% of allotment price, which is equivalent to fair value at the inception of lease) seems to be lower than the market price at the inception of lease. Therefore, at the inception of lease, it appears to be reasonably certain that such option to buy-out will be exercised by the lessee in the extant case.

The Committee also notes that the lessee also has an alternative option to renew the lease for a further term of upto 99 years without any additional cost. Thus, the renewal price is not at

fair value at the time the renewal option is to be exercised. This also indicates that the lessee has significant risks and rewards arising from the underlying asset.

The Committee further notes that, as per clause 24.11 of allotment regulations, if after purchase of land by paying buyout premium, any lessee wishes to sell its plot, the Corporation has the first right of refusal to buy at prevailing rate decided by the Price Fixation and Infrastructure Committee (PF&IC) of the Corporation. The Committee notes that this right would not be a substantive right for the purpose of lease classification since, in case the Corporation wishes to exercise its first right of refusal, the lessee would still be entitled to get the prevailing rate (which appears to be based on local SRO rates and industrial land rates), which would be akin to obtaining the fair value, from the Corporation.

Accordingly, the Committee is of the view that considering the above factors, the lease in the extant case appears to satisfy the tests laid down in Ind AS 116 and hence, should be classified as finance lease by the Corporation.

14. The Committee now examines the requirements of Ind AS 116 in respect of recognition and initial and subsequent measurement in case of finance leases as follows:

“Finance Leases

Recognition and measurement

- 67 At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as a receivable at an amount equal to the *net investment in the lease*.**

Initial measurement

- 68 The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. ...
- 69 Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

Initial measurement of the lease payments included in the net investment in the lease

- 70 At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:
- (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable;
 - (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;

- (c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;
- (d) *the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and*
- (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

(Emphasis supplied by the Committee.)

Manufacturer or dealer lessors

- 71 At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:
- (a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;
 - (b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the *unguaranteed residual value*; and
 - (c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which Ind AS 115 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in Ind AS 115.
- 72 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts.
- 73 Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged.
- 74 A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

Subsequent measurement

- 75 A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.**
- 76 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the *gross investment in the lease* to reduce both the principal and the *unearned finance income*.
- 77 A lessor shall apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.
- 78 A lessor that classifies an asset under a finance lease as held for sale (or includes it in a disposal group that is classified as held for sale) applying Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*, shall account for the asset in accordance with that Standard.”

“Finance leases

- 93 A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.
- 94 A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.”

From the above, the Committee is of the view that in the extant case, the Corporation should use the interest rate implicit in the lease to measure the net investment in the lease as per paragraph 68 of Ind AS 116. At the lease commencement date, for each lease, the Corporation should recognise the net investment in the lease at the present value of the minimum lease payments as per the requirements of paragraph 70 of Ind AS 116 and derecognise the specific underlying land leased to the individual lessee.

Further, the Committee, noting that the Corporation in the extant case offers its lessees a choice of either buying or leasing the land parcel, is of the view that in case the Corporation considers itself to be a manufacturer or dealer under Ind AS 116, the requirements of paragraphs 71-74 shall be followed. In that case, at lease commencement date, it shall:

- (a) recognise revenue at the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;

- (b) recognise the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value; and
- (c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which Ind AS 115 applies.

15. The Committee further notes that Ind AS 116 provides following guidance with regard to lease term and purchase option:

“18 An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

19 In assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease, as described in paragraphs B37– B40.

20 A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:

- (a) is within the control of the lessee; and
- (b) affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term (as described in paragraph B41).”

Appendix A to Ind AS 116 provides following definitions:

“Lease payments Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

...

- (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

...”

Appendix B to Ind AS 116 provides as follows:

“B37 At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts

and circumstances from the commencement date until the exercise date of the option. Examples of factors to consider include, but are not limited to:

- (a) contractual terms and conditions for the optional periods compared with market rates, such as:
 - (i) the amount of payments for the lease in any optional period;
 - (ii) the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and
 - (iii) the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- (b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- (c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;
- (d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives; and
- (e) conditionality associated with exercising the option (ie when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

B38 An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments in paragraph B42, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.”

The Committee notes from the above that an entity determines the lease term as the non-cancellable period of the lease, together with both: periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. Further, purchase options are assessed in the same way as options to extend or terminate the lease. An option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset. At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to

terminate the lease. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

In the extant case, the fact that the lessee who has made the lease payments upfront does not have to make any further payment to the Corporation upon the exercise of purchase option after 10 years, indicates that there may be economic incentive to exercise the purchase option. In other cases, the additional payments for purchase options are capped to 20% of the lease premium. Considering these factors, the Committee is of the view that in the extant case, the lessee is reasonably certain to exercise the purchase option, in which case, the exercise price is included as a lease payment.

Initial direct costs, except those incurred by a manufacturer or dealer, shall be included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The Corporation shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. The Corporation shall also apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease.

In case the Corporation considers itself as manufacturer or dealer under Ind AS 116, it shall recognise costs incurred in connection with obtaining a finance lease at the commencement date as an expense. Costs incurred in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

16. With respect to accounting for land yet to be leased out by the Corporation, the Committee notes that Ind AS 40, 'Investment Property' states the following:

“Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes; or**
- (b) sale in the ordinary course of business.”**

“8 The following are examples of investment property:

- (a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- (b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
- (c) a building owned by the entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases.
- (d) a building that is vacant but is held to be leased out under one or more operating leases.

- (e) property that is being constructed or developed for future use as investment property.
- 9 The following are examples of items that are not investment property and are therefore outside the scope of this Standard:
- (a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see Ind AS 2, *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
 - ...
 - (c) owner-occupied property (see Ind AS 16 and Ind AS 116), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal;
 - (d) [Refer Appendix 1]
 - (e) property that is leased to another entity under a finance lease.
- 10 Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.”

From the above, the Committee notes that the classification as investment property depends on the intention or purpose for which the property is held. The Committee notes that the Corporation has several land parcels which may be leased out at different points of time.

Further, the Committee notes that, as per paragraph 8(b) of Ind AS 40, land held for a currently undetermined future use shall be classified as investment property. Therefore, if an entity has not determined that it will use the land as owner-occupied property or for sale/finance lease in the ordinary course of business, the land is regarded as held for capital appreciation.

In the extant case, the Corporation leases out the land parcels on finance lease basis and gives a purchase option under the lease, which is reasonably certain to be exercised (as discussed in paragraph 15 above). Further, considering the fact that earlier before introduction of A.P. Industrial Development Policy 2020-23, the Corporation was engaged in allotment of land on ‘Out Right Sale Model’, where the revenue was being recognised as per the principles of Ind AS 115 on execution of sale agreement, and the inventory of land yet to be sold was apparently recognised as per Ind AS 2, ‘Inventories’, and the above-mentioned Policy was newly introduced to reduce the upfront costs of the allottees of land, the Committee is of the view that, in the extant case, the intention of the Corporation in holding the lands does not appear to be to earn rentals or for capital appreciation and, therefore, it would not be inappropriate to continue to classify the land properties as inventories under Ind AS 2.

D. Opinion

17. On the basis of above, the Committee is of the opinion that in the extant case, the lease arrangement would, in substance, satisfy the tests laid down in paragraphs 63 and 64 of Ind AS 116 and hence, should be classified as finance lease by the Corporation, as discussed in paragraph 13 above. Further, the Corporation should follow the accounting treatment mentioned in paragraphs 10-16 above.
