

Query No. 14

Subject: Accounting for leasehold land and applicability of Ind AS 116.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) is a special purpose public company established by the Government of Karnataka (represented by Karnataka Industrial Acquisition and Development Board or ‘KIADB’) and the Government of India (represented by National Industrial Corridor Development and Implementation Trust or ‘NICDIT’). The primary objective of the Company is to implement the National Industrial Corridor Programme of the Government and to develop the Tumakuru Node of Chennai Bengaluru Infrastructure Project. As per the National Industrial Corridor Programme, the Government aims to develop industrial cities which can compete with best manufacturing and investment destinations in the world.

2. The querist has stated that as per the shareholders agreement, it was mutually agreed upon that the project would be equally financed by both the shareholders, i.e., Government of Karnataka and Government of India. Accordingly, the KIADB on behalf of the Government of Karnataka has contributed approximately 1668 Acres of land and NICDIT has contributed money equivalent to the value of land on behalf of the Government of India. Subsequent to obtaining both the land and financial contribution, the Company would develop basic infrastructure facilities such as roads, electricity, water, sewage etc. and provide the same to the industrial units for establishment of factories.

3. In compliance with rules and regulations prevalent in the state of Karnataka for the transfer of the industrial land, a lease agreement for a period of 99 years was executed in favour of the Company and the possession of the land was handed over to the Company. As per the terms of the lease agreement, the lessee was entitled to exercise an option for further extending the lease terms for two terms of 99 years each. Subsequent to the execution of lease agreement, the Government of Karnataka amended the policy for the allotment of land to industrial units and permitted Central-State Joint Venture Companies to obtain land on lease-cum sale basis for a period of two years with an option for execution of sale deed either on completion of the project or on the expiry of the lease period. Subsequent to amendment in policy for allotment of industrial land by the Government of Karnataka, the tenure of the lease agreement between the Company and KIADB was amended from 99 years to 2 years. Further, the Company intends to register the land in its own name at the end of two years.

4. On obtaining the possession of land, the Company undertook various development activities on the aforesaid land in order to ensure availability of basic infrastructure facilities such as roads, electricity, water supply, drainage system etc. prior to leasing/ selling the land to industrial units. As the land was obtained by the Company on lease from KIADB, lease accounting as prescribed by Indian Accounting Standard (Ind AS) 116, ‘Leases’ was applied and it recognised both right-of-use (RoU) asset and lease liability simultaneously.

5. As per paragraph 47 of Ind AS 116, “a lessee shall either present in the balance sheet, or disclose in the notes:

¹ Opinion finalised by the Committee on 1.8.2024.

- (a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the balance sheet, the lessee shall:
 - (i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
 - (ii) disclose which line items in the balance sheet include those right-of-use assets. ...”

Given that the land would ultimately be owned and registered in the name of the Company, the Company has opted to disclose right-of-use asset under ‘inventory’ as according to the querist, the above paragraph permits the Company to disclose right-of-use asset within the same line item in which the corresponding assets would be presented if they were owned.

6. During the yearly review by C&AG, it was suggested that the right-of-use assets must be presented as a separate line item on the face of the balance sheet and should not be disclosed as a part of inventory.

7. *Amortisation of right-of-use asset:*

As per Ind AS 116, the lessee shall apply depreciation requirements of Ind AS 16 for depreciation of right-of-use assets. However, in a few specific cases depreciation of RoU shall be done as per paragraph 32 of Ind AS 116 which specifies the following:

“If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the *useful life* of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the *useful life* of the right-of-use asset or the end of the lease term.”

Given that it is certain for the Company to register the land in its name and as the value of equity shares allotted to KIADB is equivalent to the cost of land, the RoU must be depreciated over the useful life of the asset. In the instant case, as the useful life of the asset, i.e., land is infinite, the Company has not amortised the right-of-use asset.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to:

- (i) Whether the method of presentation of right-of-use asset adopted by the Company is appropriate.
- (ii) Whether the accounting policy adopted by the Company of not depreciating the right-of-use asset pursuant to paragraph 32 of Ind AS 116 is appropriate.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to presentation and

amortisation of right-of-use asset (land) subsequent to execution of lease-cum-sale agreement between the Company and KIADB. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, whether the land was allotted at fair value or not by the promoter company and its compliance (if any) with Ind AS 20, 'Accounting for Government Grants and Disclosure of Government Assistance', compliance with Ind AS 115, 'Revenue from Contracts with Customers' relating to timing of recognition and measurement of revenue, accounting for Shareholders Agreement, treatment to be accorded (if any) under Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', etc.

The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various legal enactments, such as, Goods and Service Tax Act, Indian Contract Act, Companies Act, 2013 etc.

10. The Committee notes from the facts supplied and the annual report of the Company for the financial year 2022-23 that for achieving the objective of the industrial township project, a Shareholders Agreement (SHA) dated 6th July 2018 was entered into between two statutory bodies viz. (i) Karnataka Industrial Areas Development Board (KIADB and the lessor of land) and (ii) National Industrial Corridor Development and Implementation Trust ("NICDIT"). Pursuant to the SHA, the Company was incorporated as a special purpose vehicle on 1st November, 2018 and KIADB was required to transfer and grant lease of 1722-30 acres of land (in two tranches of 1668-12 acres and 54-18 acres) to the Company. Pursuant to achieving the execution of the project objective, Lease Agreement dated 24.03.2021 was entered into and registered on 29th March 2021 in relation to 1668-12 acres of land. The key clauses of the Lease Agreement are as follows:

“GRANT OF LEASE AND POSSESSION

2.1 In consideration of the covenants contained in the Shareholders Agreement, this Lease Agreement and payment of the Lease Rent, the Lessor grants leasehold rights (“Lease”) in respect of the Site, to the Lessee and the Lessee agrees to accept the Lease from the Lessor, for the duration of the Term together with all and singular rights, liberties, privileges, easements, benefits, rights of way, paths, passages whatsoever in or appurtenant to the Site or any part thereof, and to hold, possess, use and enjoy the Site and/or any part thereof, in accordance with the provisions of this Lease Agreement, subject always, however, to the terms and conditions contained in the Shareholders Agreement. The Parties agree that the possession of the Site shall be handed over to the Lessee in accordance with the provisions of the Shareholders Agreement.

2.2 Subject to and in accordance with the terms of this Lease Agreement and those set out in the Shareholders Agreement, the Lessee shall have the right and be at liberty to undertake, all and any activities, including but not limited to carrying out any surveys, investigations and soil tests, zoning, development and construction of the Industrial Township, Trunk Infrastructure and Strategic Projects and to construct, erect, renovate, repair, alter, or otherwise deal with the Site and any structure or structures standing thereon or to be constructed

hereafter and the works carried out therein, and shall carry out any modifications thereto as it deems fit, in accordance with the Applicable Laws.”

“3. TERM

The Lease granted pursuant hereto shall be for a period of 99 (ninety-nine) years commencing from the date of this Agreement and shall be renewed in the manner specified hereunder (**the “Term”**).

The Lessee shall be entitled, by issuing a written notice to the Lessor, not later than 1 (one) year prior to the expiry of the original 99 (ninety-nine) years, to renew the Lease by another term of 99 (ninety-nine) years and upon receipt of such notice, the Lessor shall renew the Lease for another 99 (ninety-nine) years. Upon expiry of each term of 90 (ninety) years, the Lessee shall be entitled to seek further renewal of the Lease for a period of 99 (ninety-nine) years in accordance with the provisions hereof.

...”

“6. LESSOR’S OBLIGATIONS AND COVENANTS

The Lessor hereby agrees and warrants that:

...

(b) subject to the terms of the Lease Agreement and the Shareholders Agreement, the Lessee shall be entitled to possess, hold, use and enjoy the Site and every part thereof during the Term of the Lease Agreement, without any interruption by the Lessor except as per the provisions of the Shareholders Agreement;

(c) the Lessee shall, during the Term of the Lease Agreement, enjoy free ingress and egress to and from the Site without any hindrance;

...

(e) subject to the terms of the Shareholders Agreement, the Lessee shall be entitled to sub-lease, license or create any other Encumbrance or rights in the Site or any part thereof, in favour of any third party; and

...”

“7. LESSEE’S OBLIGATIONS AND COVENANTS

Lessee hereby covenants, agrees and represents that:

...

(b) it shall use the Site only for the purpose of carrying out its obligations under the Shareholders Agreement in accordance with the terms of the Shareholders Agreement and Applicable Laws;”

Further, the Committee notes that Clause 4.2.1 of SHA provides as follows:

“KIADB hereby undertakes to transfer and grant lease of the Site (along with all rights, title and interest of the Site) to the SPV, free of all and any Encumbrances of any kind, and shall ensure that the SPV shall have access to the Site for undertaking all

and any activities, including but not limited to carrying out any surveys, investigations and soil tests, zoning, development and construction of the Industrial Township, Trunk Infrastructure and Strategic Projects. The Parties agree that the Site shall be leased, as per Applicable Laws, for the period of 99 (ninety-nine) years, with automatic renewal on every expiry of the term thereof, in accordance with the terms of the Lease Agreement. The Lease agreement executed for such transfer shall not place any onerous conditions on the SPV and shall be in accordance with the Lease Agreement, substantially in the form set forth in **Schedule-E** of this Agreement.”

11. Subsequent to the lease agreement, the Government of Karnataka vide its Order dated 01.01.2022 has accorded approval for allotment of land by KIADB to Central Government Undertakings/ PSUs, State Government Undertakings / PSUs, Central State Joint Venture Companies on 2 years lease-cum-sale basis and if the lessee has implemented the project and utilised more than 50% of the area allotted and has performed all the conditions of lease-cum-sale deed. The sale deed shall be executed during the currency of the lease period or at the end of 2 years. Consequent to the notification, the Board of Directors of the Company at its meeting held on 8th May 2023 resolved to request KIADB for execution of supplementary lease cum sale agreement to the Original lease agreement. Accordingly, Supplementary Lease Agreement dated 22nd August 2023 was executed, which inter alia, has the following key clauses:

“1. For the title “LEASE AGREEMENT” appearing in 1st page of the Principal Lease Agreement, the words “LEASE CUM SALE AGREEMENT” shall be substituted.

...

3. For the words “99 (ninety-nine) years commencing from the date of this Agreement” in 1st & 2nd line of clause 3, Page 6 of the Principal Lease Agreement, the words “2 (two) years computed from the date of this agreement” shall be substituted.

“The Lessor shall sell the Scheduled Property to the Lessee during the currency of the lease period or extended period, if any, if the lessee has performed all the conditions herein contained and committed no breach thereof and all attendant expenses in connection with the sale, such as stamp duty, registration charges etc., shall be borne by the Lessee”.

The other terms and conditions contained in the Principal Lease Agreement as obligatory part against each other would remain unchanged and they are enforceable without any alteration or modification.

No consideration has been received for execution of this Supplementary Lease Agreement.”

12. The Committee further notes from Note 1 of the financial statements of the Company for the financial year 2022-23 that the Company will exploit development of land for commercial purposes, which shall include the right to sell, lease, sub-lease or license any or all parts thereof, demand and collect fee, charges, and undertake such other activities incidental thereto or necessary for the same. Further, as per Note 6 of financial statements, the Company prior to leasing/ selling the developed land to industrial units has opted to disclose

the lease hold land which is in nature of Right of Use Assets as an 'Inventory' given the fact that supplementary lease agreement has been executed between KIADB and the Company and as mentioned in the Facts of the Case that it will ultimately be owned and registered in the name of the Company.

13. 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.”
- “32 If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the *useful life* of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the *useful life* of the right-of-use asset or the end of the lease term”

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.”

14. The Committee further notes the following paragraphs of 'Basis for Conclusions' to International Financial Reporting Standard (IFRS) 16 'Leases' (corresponding to Ind AS 116), issued by the International Accounting Standards Board (IASB) which state 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) for a long-term lease of land (for example, a 99-year lease), the present value of the lease payments is likely to represent substantially all of the

fair value of the land. In this case, the accounting applied by the lessee will be similar to accounting for the purchase of the land. If the lessee obtains control of the land, it will account for the contract as the purchase of the land by applying IAS 16 *Property, Plant and Equipment*, rather than by applying IFRS 16.”

“BC138 The IASB considered whether to include requirements in IFRS 16 to distinguish a lease from the sale or purchase of an asset. The IFRS Interpretations Committee had received questions about whether particular contracts that do not transfer legal title of land should be considered to be a lease or a purchase of the land.

BC139 The IASB decided not to provide requirements in IFRS 16 to distinguish a lease from a sale or purchase of an asset. There was little support from stakeholders for including such requirements. In addition, the IASB observed that:

- (a) the accounting for leases that are similar to the sale or purchase of the underlying asset would be similar to that for sales and purchases applying the respective requirements of IFRS 15 and IAS 16; and
- (b) accounting for a transaction depends on the substance of that transaction and not its legal form. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, those rights meet the definition of property, plant and equipment in IAS 16 and would be accounted for applying that Standard, regardless of whether legal title transfers. If the contract grants rights that do not represent the in-substance purchase of an item of property, plant and equipment but that meet the definition of a lease, the contract would be accounted for applying IFRS 16.

BC140 IFRS 16 applies to contracts that convey the right to use an underlying asset for a period of time and does not apply to transactions that transfer control of the underlying asset to an entity—such transactions are sales or purchases within the scope of other Standards (for example, IFRS 15 or IAS 16).”

From the above, the Committee notes that accounting for a transaction depends on the substance of that transaction and not on its legal form. Where a lease contract is similar to the sale or purchase of the underlying asset, it should be accounted for as sale and purchase applying the respective requirements of applicable Standards such as, Ind AS 115 and Ind AS 16 etc. Further, if a contract grants rights that represent the in-substance purchase of an item transferring control of the underlying item/asset, the contract should be accounted for applying the respective Standards, such as, Ind AS 115.

Accordingly, with regard to transfer of ‘control’, the Committee notes the following requirements of Ind AS 115:

- “33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities

from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

- (a) using the asset to produce goods or provide services (including public services);
- (b) using the asset to enhance the value of other assets;
- (c) using the asset to settle liabilities or reduce expenses;
- (d) selling or exchanging the asset;
- (e) pledging the asset to secure a loan; and
- (f) holding the asset.”

From the above, the Committee notes that paragraph 33 of Ind AS 115 states that control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

15. The Committee also notes that as per the requirements of Ind AS 116 (paragraph B37), for determining lease term, while making an assessment as to whether the lessee is reasonably certain to exercise an option to purchase the underlying asset, 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. Thus, all the current and expected facts and circumstances have to be considered for determining the lease term. In this context, in the extant case on a perusal of the Lease Agreement including Supplementary Lease Agreement and Shareholders Agreement, the Committee notes that the land covered under the lease arrangement will ultimately be transferred to the Company at the end of 2 years from the date of execution of Supplementary Lease Agreement or when it has implemented the project and utilised more than 50% of the area allotted. Further, no further consideration for transfer of the rights is required to be paid. Furthermore, Lease Agreements and Shareholders Agreement specifically provide that lessee shall be entitled to sub-lease, license or create any other encumbrance or rights in the site (land) or any part thereof, in favour of any third party. Therefore, keeping in view the facts and circumstances of the case, the Company has conveyed that it is reasonably certain that the land will be registered in the name of the Company at the end of the two years or on utilisation of more than 50% of the area allotted which is expected to be completed shortly, leading to transfer of the land. Also, since no other significant restrictions have been placed, in the extant case, in substance, the Company appears to have ‘control’ over the land leased/provided to it by the KIADB. The arrangement in the extant case, represents the in-substance purchase of land. Accordingly, the Committee is of the view that in the extant case, the requirements of Ind AS 116 will not be applicable on this arrangement with KIADB. Thus, the disclosure or amortisation requirements of Ind AS 116 are not applicable in the extant case.

16. The Committee further notes the following disclosures made by the Company in its financial statements for the year ending on 31st March, 2023:

“Inventories

...

Pursuant to the above, supplementary lease agreement modifying the lease period to 2 years has been executed between KIADB and the Company. The Company is in the process of arranging for registration of the aforesaid agreement.

Accordingly, Right of Use Asset and Lease Liability are recognised by considering the lease commencement date as 24 March 2021 and the lease end date as 31 March 2025 i.e. 2 years from the balance sheet date as per G.O Order CI 132 SPQ(e) dated 01.01.22.”

“Other Current Assets

...

Note: Company is engaged in the development of ...Infrastructure Industrial Corridor Project of the Government of India. As per the Project Master Plan, the Company intends to develop and lease out land to allottees for various purposes such as industrial, residential, commercial and civic amenities. As per GST laws, premium received on lease of industrial land attracts NIL rate of GST. Given the above, the Company has reversed GST Input Tax Credit of Rs 57.11 Lacs as per Rule 43 of COST Rules, which is 47% of the total area available for lease as per Project Master Plan and included the aforesaid amount in the value of inventory.”

From the above, the Committee notes that the entire cost of land and development expenditure has been disclosed under ‘Inventory’. It is also noted from the financial statements that the Company may also lease developed land to potential buyers instead of selling the developed land. In this regard, 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.”

17. 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 from the disclosures that the developed land parcels may either be sold or leased out at different points of time. Thus, in case the intention of the Company is to sell the land post development or to lease it to another entity under a finance lease, it should be recognised as ‘inventory’. However, if and to the extent, the same is held for leasing to another entity under ‘operating lease’ to earn rentals, it should be recognised as ‘investment property’. Further, 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 the Company 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 should be regarded as held for capital appreciation and recognised as ‘investment property’. Accordingly, the Committee is of the view that the Company will have to make a judgement based on its own facts and circumstances and intention to hold the land, so as to determine whether it would be appropriate to continue to classify the entire cost of land properties as inventories under Ind AS 2.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion that:

- (i) and (ii) As the arrangement with KIADB in the extant case represents the in-substance purchase of land, as discussed in paragraph 15 above, the requirements of Ind AS 116 will not be applicable on this arrangement and accordingly the question of presentation as Right of Use Asset and amortisation of the same does not arise. The Company, depending on its own facts and circumstances and its intention to hold the land, should comply with the requirements of Ind AS 2/ Ind AS 40 in regard to land under development, as discussed in paragraph 17 above.
