

What lease accounting demands after the adoption project ends

Years after adoption, lease accounting is still a common source of audit adjustments. The errors have moved away from first-time recognition and into modifications, variable payments, and discount rates.

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AT A GLANCE

- Adoption was a project; lease accounting is a process. Most errors now come from events after commencement, such as modifications, reassessments, and renewals handled inconsistently.
- Escalations tied to turnover, usage, or an index are the most misjudged area. Payments that look variable are often fixed in substance, and belong in the liability.
- The incremental borrowing rate is an estimate, and auditors increasingly test it like one. A single blended rate applied across tenors and currencies rarely holds up.
- Lessees with more than about fifty leases need controls at portfolio level: a lease register with event triggers, a standard memo for each modification, and a quarterly completeness reconciliation.

When IFRS 16 took effect in 2019, and Ind AS 116 alongside it in India, the effort was concentrated and highly visible. Companies had to find every lease, build the right-of-use assets and lease liabilities, choose their transition options, and explain a balance sheet that suddenly carried assets and debt it had never shown before. They treated adoption as a project, and most of them delivered that project competently.

The standard was never a one-off exercise, though. A lease portfolio is a living population. Contracts renew, end early, and get renegotiated mid-term, and they carry rent escalations linked to everything from the consumer price index to store revenue. Each of those events has a prescribed accounting treatment, and each gives the books a chance to drift away from the contracts. When we review lease accounting in manufacturing, retail, and services groups, the findings are remarkably consistent, and they are rarely about the present-value arithmetic.

Modifications and remeasurements are different, and the difference is material

The most frequent error we see is treating every change to a lease the same way. IFRS 16 draws a clear line between two situations that look alike in a rent ledger but diverge in the accounts:

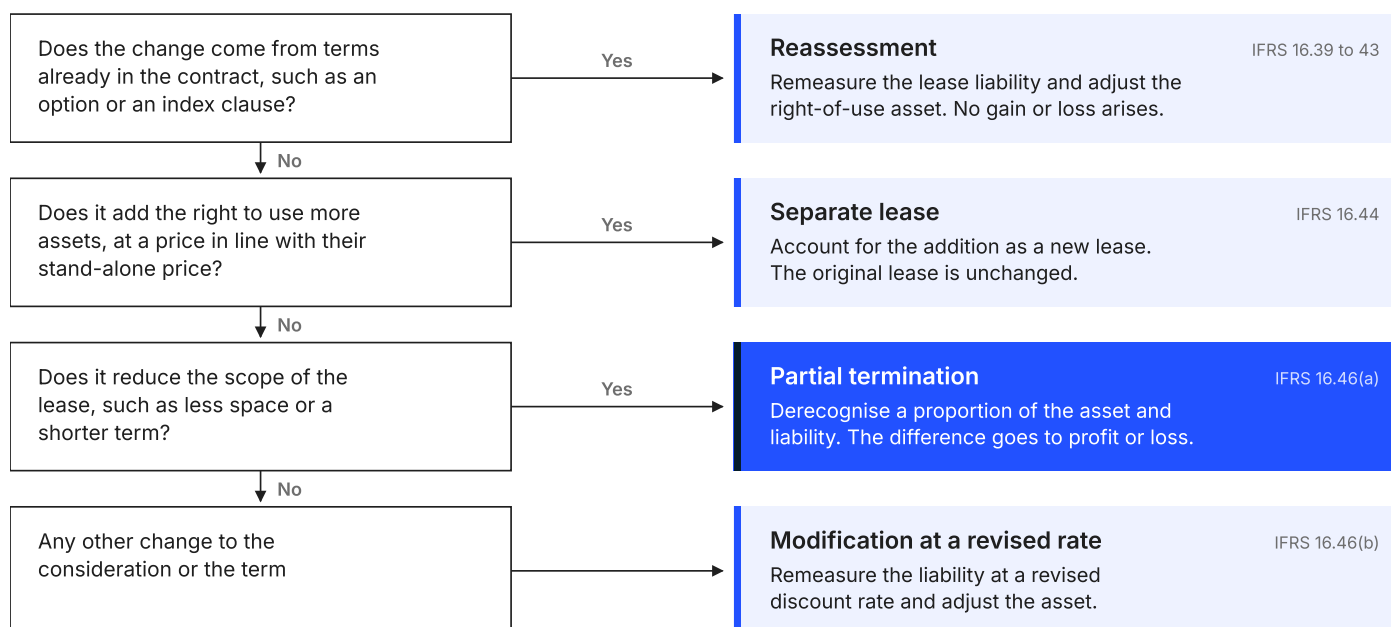
- **Reassessments** arise from the lease's own terms, such as exercising an extension option already in the contract, or a change in payments under an existing index clause. They remeasure the liability against the right-of-use asset, using either the original or a revised discount rate, depending on the trigger.
- **Modifications** are renegotiations that change the scope of the lease or its price beyond the original terms: adding floors to a leased building, agreeing to shorten the term, or resetting rent to market. They may need to be accounted for as a separate lease, as a partial termination with a gain or loss, or as a remeasurement at a revised rate.

That distinction decides whether any profit or loss arises at all. A partial termination, surrendering two floors out of five, for instance, means derecognising a proportionate slice of the right-of-use asset and the liability, with the difference going to profit or loss. We regularly find these treated as simple remeasurements, which buries the gain or loss inside the asset. Across a portfolio renegotiated during a downturn, the cumulative misstatement can run to crores.

EXHIBIT 1

One renegotiation can reach the accounts in four different ways, and only one of them touches profit or loss

Decision path for a change to an existing lease, from the lessee's side



Simplified for illustration. Whether a change is a modification or a reassessment, and which discount rate applies, depends on the contract.

Source: IFRS 16 Leases, paragraphs 39 to 46 (mirrored in Ind AS 116); SA&A analysis

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The books drift away from the contracts one renewal at a time. By year three, the lease register and the legal reality are different documents.

Variable payments and the in-substance fixed trap

Payments that vary with usage or performance are left out of the lease liability and expensed as they occur. That exclusion has become a loophole, usually by accident. The standard is clear that **in-substance fixed payments** belong in the liability: payments dressed up as variable that are unavoidable in any realistic scenario.

Three patterns deserve particular attention:

1. **Floors under revenue-linked rents.** A retail lease that charges 8 percent of store revenue, subject to a minimum monthly rent, is not a variable lease. The minimum is fixed and has to be capitalised; only the excess above it is variable.

2. **Escalations linked to an index.** Rents tied to CPI enter the liability at the current index and are remeasured when the cash flows change. They are not ignored because they will change. Teams that capitalise year-one rent flat for the whole term understate the liability in inflationary years.
3. **Payments avoidable only in theory.** A charge that stops only if the lessee stops using the asset altogether, such as a per-shift charge on equipment that runs three shifts because the business needs it to, is not truly variable.

The exposure is not only about measurement. The maturity analysis and the variable payment disclosures that lenders and analysts rely on are only as complete as the liability beneath them, so an understated liability becomes an incomplete disclosure as well.

The discount rate is an estimate, so treat it as one

Almost no lease states the rate implicit in it, so nearly every lessee uses its incremental borrowing rate. At adoption, many companies fixed a single rate, often their working capital borrowing rate, and have used it with light adjustments ever since. That approach falls short on three points the standard is explicit about:

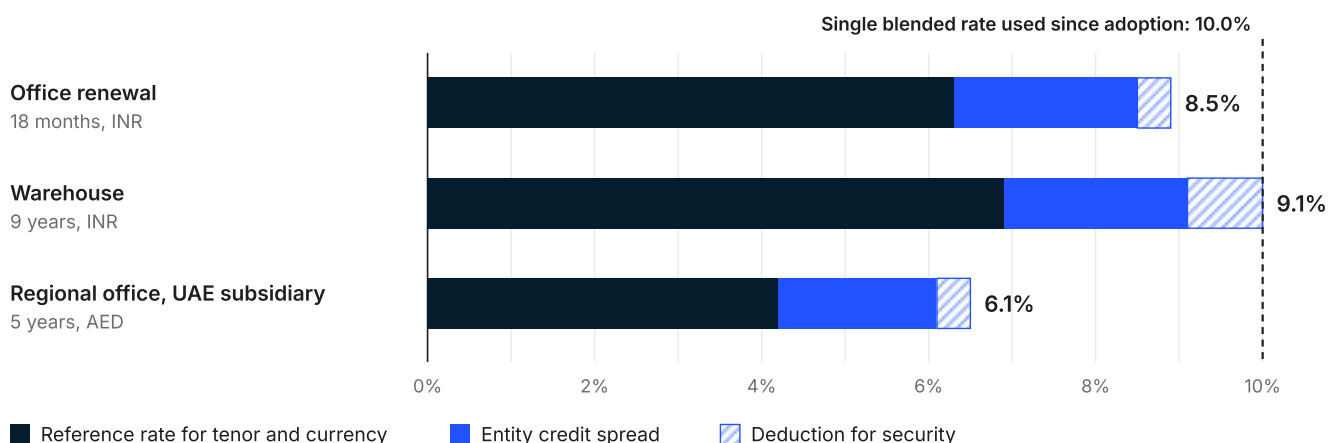
- **Term.** A nine-year warehouse lease and an eighteen-month office renewal do not share a borrowing rate. The rate has to reflect the lease term, which means working from a curve rather than a single number.
- **Security.** The rate assumes borrowing on similar security, which is closer to asset-backed pricing than to unsecured working capital lines.
- **Economic environment.** A subsidiary leasing in the UAE or the US cannot borrow its Indian parent's rupee rate. Currency and jurisdiction move the rate materially.

A defensible method is not onerous: a documented build-up from a reference rate for the tenor and currency, an entity credit spread, and an adjustment for security, refreshed at a stated frequency and applied lease by lease. What does not survive scrutiny is a spreadsheet cell holding "10%" with no memo behind it.

EXHIBIT 2

One lease portfolio, three defensible discount rates, and a blended rate that fits none of them

Incremental borrowing rate built up for three leases held by the same group, percent



Illustrative figures. The hatched segment is the reduction for borrowing secured on the leased asset, deducted from the reference rate plus spread.

Source: IFRS 16 Leases, Appendix A, definition of incremental borrowing rate (mirrored in Ind AS 116); SA&A analysis

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What disciplined lessees do differently

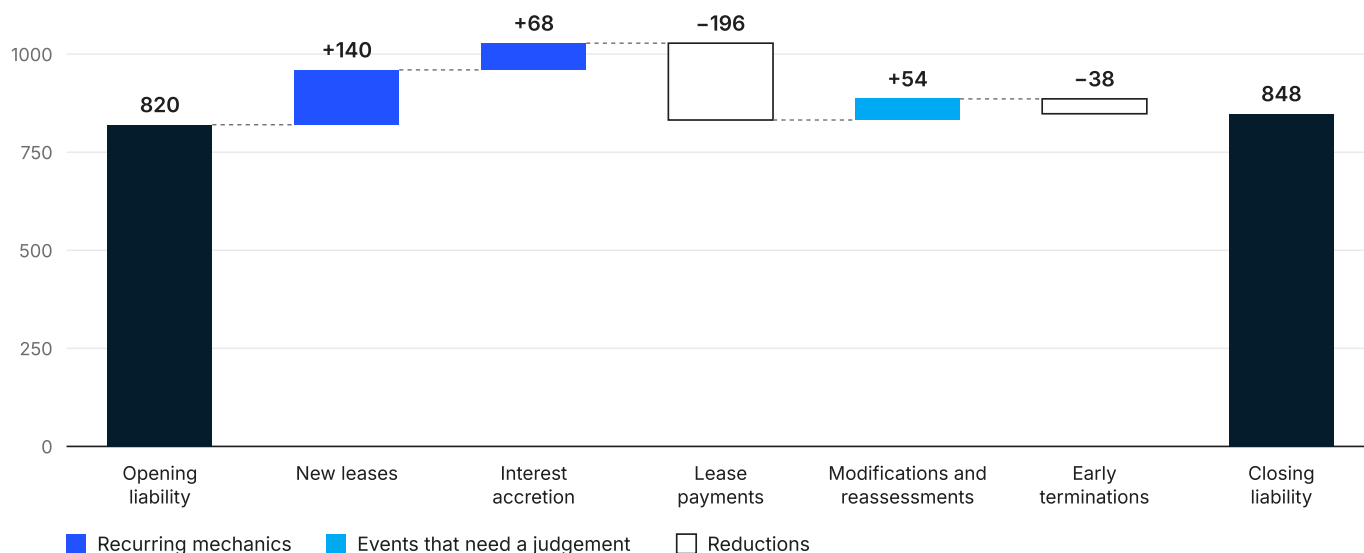
The companies that stopped generating lease findings did not buy their way out with software. Several of them still run well-controlled spreadsheets. What they did was make four structural changes:

- 1. One lease register as the single source of truth.** A controlled register holding every contract, its key dates, options, escalation terms, and the accounting conclusions reached, reconciled each quarter to legal's contract repository and to rent in the general ledger. That reconciliation is the completeness control. Without it, leases signed by business teams only surface when the auditor samples rent payments.
- 2. Event triggers owned outside finance.** Renewals, exits, and renegotiations are business decisions made months before finance hears about them. Disciplined lessees build lease events into the contract approval workflow, so a modification memo reaches the reporting team when the amendment is signed, not when the cash flow changes.
- 3. A standard modification memo.** One page for each event, setting out what changed commercially, which paragraph of IFRS 16 applies, the numbers before and after, and the effect on profit or loss. It turns each judgement into evidence, and cuts audit queries sharply.
- 4. An annual reassessment sweep.** Once a year, before the audit, someone reads through the portfolio for options now likely to be exercised, changed economic incentives, and index movements. Reassessment is a continuous obligation, but a disciplined annual sweep catches what the year missed.

EXHIBIT 3

The lease liability reconciliation shows where the judgement sits: in the changes after commencement

Illustrative movement in a retail group's lease liabilities over one year, ₹ crore



Illustrative figures. Modifications, reassessments, and terminations each need an accounting conclusion; the other movements follow mechanically once the lease is set up.

Source: IFRS 16 Leases; IAS 7 Statement of Cash Flows, paragraphs 44A to 44E (mirrored in Ind AS 116 and Ind AS 7); SA&A analysis

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The reporting opportunity inside a lease portfolio

IFRS 16 also changed what sophisticated readers can see. Lease liabilities sit inside net debt for most lenders and rating agencies, right-of-use assets affect return on assets, and the maturity analysis shows the shape of committed outflows. A company that manages its lease portfolio deliberately, laddering expiries, negotiating break options where flexibility has value, and capitalising escalations accurately, is managing its credit profile as well as its compliance.

That is the case worth making inside the company. Done well, lease accounting keeps a significant form of financing visible and priced, because a lease portfolio is financing.

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