Chapter V

Accounting practices of leasing companies
The growth of leasing and its wide acceptance as a method of acquiring use of assets gave rise to some interesting issues. The most debated issue has been to identify the appropriate accounting method to record lease transactions in the books of lessors and lessees. Over the years attempts have, however, been made by several International Accounting Bodies to develop accounting standards for lease transactions to determine the appropriate accounting methods for lease transactions. However, no uniform and consistent method of accounting, for lease transactions was followed by lessors and lessees in India. The leasing companies are following varied accounting practices with respect to lease transactions.

The absence of uniform accounting practices, followed by lessees and lessors, led the Institute of Chartered Accountants of India (ICAI) to develop some guidelines to bring about uniformity and consistency in accounting for lease transactions. In February, 1987, ICAI brought a 'Guidance Note' on 'Accounting for Leases', by issuing an 'Exposure Draft'.

GUIDANCE NOTE ISSUED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA FOR LEASE TRANSACTIONS:

With the leasing industry acquiring increasing importance in the financial system, the need for proper accounting of leases has attracted the attention of accounting bodies all over the world. Efforts for developing standards for lease accounting can be traced back to the late forties in the United States, when leasing as an industry was still in its infancy. The Accounting Research Bulletin of October,
1949, was directed specifically towards leases and prescribed that material obligation under such transactions should be disclosed in the balance sheet and that leased assets should be shown as fixed assets along with other owned assets.

At present, there are four standards available, which deal in great detail on how lessors and lessees should account for lease transactions in their books. In India also, The Institute of Chartered Accountants of India issued ‘Guidance Note’ on disclosure practices for lessors and lessees.

It is noteworthy that all the standards and guidance notes issued by various accounting bodies distinguish between an Operating Lease and Financial Lease. Following this classification, these international accounting bodies have suggested broadly the following treatment for lease transactions.

With the entry of a large number of lessors in the Indian leasing industry, each following varied accounting practices, the subject of lease accounting in India has rightly drawn the attention of the ICAI.
The Institute of Chartered Accountants of India (ICAI) brought forth a guidance note on 'Accounting for Leases' in February, 1987. It seems that the purpose of the proposed guidance note is to develop sound accounting practices and bring about uniformity and compatibility in accounting treatment of lease transaction. Major issues, procedures and recommendations have been discussed in the following paragraphs.

**Accounting for Leases in the books of Lessor:**

**Financial Lease:**

Assets leased under finance leases, except those under hire-purchase agreements, should be disclosed as “Assets given on lease” under the head “Fixed Assets” in the balance sheet of the lessor. The classification of assets given on lease should correspond to that adopted in respect of other fixed assets.

Lease rental received/receivable under a finance lease should be shown separately under ‘Turnover’ in the profit and loss account of the relevant year. The corresponding annual capital recovery charge to the profit and loss account should represent recovery over the basic lease period, as the net investment in the leased asset at the inception of the lease. The said charge should be calculated by deducting the finance income for the period from the lease rental for that period. This annual charge should be split into two parts: one representing the minimum statutory depreciation (e.g. as per section 205 and 350 of the Companies Act, 1956)
and the balance representing special lease depreciation, and both should be
disclosed separately in the profit and loss account.

For arriving at the book value of the concerned leased asset, for the purpose
of preparation of the balance sheet, the composite charge, (i.e. both minimum
statutory depreciation and special lease depreciation) should be deducted from the
net investment in the lease in the first year of the lease and from the book value at
the beginning of subsequent years. The minimum statutory depreciation for the
years subsequent to the first year, should be calculated by applying the relevant
depreciation rate to the book value so arrived. According to the method, the income
in respect of the financial lease, would be recognized as a constant periodic rate of
return on the lessors' net investment outstanding in the lease.

The finance income should be calculated by applying the interest rate implicit
in the lease to the net investment in the lease at the beginning of the relevant period.

The net investment in the lease may often be equal to the capital cost/fair
value of the asset at the inception of the lease. However, as per the definition, net
investment is the difference between the gross investment in the lease (i.e. the
aggregate of the minimum lease payment from the standpoint of the lessor and any
unguaranteed residual value accruing to the lessor) and the unearned finance
income (i.e. the difference between the lessors' gross investment in the lease and its
present value).
The initial direct costs such as commissions and legal fees often incurred by lessors in negotiating and arranging the lease should normally be expensed in the year, in which they are incurred.

**Operating Lease:**

Under an operating lease, the risk and rewards incidental to ownership of an asset remain with lessor. Therefore, the asset should be treated, by the lessor, as a depreciable asset and rentals received should be included in income over the lease term.

The costs including depreciation, incurred in earning the rental income should be charged to income. The rental income (excluding receipts for services provided such as insurance and maintenance) should normally be recognized on a straight line basis over the lease term, even if, the receipts are not on such a basis, unless, another systematic basis is more representative of the time pattern of the learning process contained in the lease. A leased asset for an operating lease should be depreciated on a basis consistent with the lessors’ normal depreciation policy for similar assets.
The initial direct costs incurred by lessors in negotiating and arranging the lease should be expensed in the year, in which they are incurred.

The lessor companies should disclose the accounting policies followed with regard to accounting for income under finance lease, valuation of assets acquired under the lease and charge for depreciation.

**Accounting for Leases in the books of Lessee:**

**Finance Lease:**

A lessee should disclose assets acquired under finance lease separately in the balance sheet under the head "Fixed Assets" at cost/fair value (at the inception of the lease) less notional depreciation (in accordance with his normal depreciation policy) without adding the amount to the gross block. This information can also be disclosed by way of a note to the accounts. The depreciation should also be made with regard to:

(I) assets acquired under the lease with an option to purchase the same and the price at which such option to purchase can be exercised; and

(II) assets acquired under the lease without an option to purchase.
The lease rentals should be accounted for on accrual basis over the lease term so as to recognize an appropriate charge in this respect in the profit and loss account, with a separate disclosure thereof. In other words, aggregate of the lease rentals payable over the lease term should, unless another systematic basis is more representative of the time pattern, be spread over the term on straight line basis, irrespective of the payment schedule as per the terms and conditions of the lease. The excess of the lease rentals, paid over the amount accrued in respect thereof, should be treated as pre-paid lease rental and vice-versa.

Operating Lease:

The lease rentals under operating lease should also be accounted for on the basis of above facts.

INTERNATIONAL ACCOUNTING STANDARDS:

The four international accounting standards are:

(I) Financial Accounting Standard Board – 13;

(V) International Accounting Standard – 17;

(VI) Accounting Standard Committee’s (SSAP) – 21; and

(IV) Australian Accounting Research Foundation’s (ASS) – 17.
RECOMMENDATIONS OF THE FINANCIAL ACCOUNTING
STANDARD BOARD: FASB – 13

Statement of financial accounting standard no. 13 represents the fruition of a long debate within the accounting profession and the financial community. It was published in 1976 and has become generally acceptable in the USA. Subsequent to FASB – 13, the Board has issued seven amendment and six interpretations of this statement. 

This statement classified leases into:

(a) capital leases or finance leases and

(b) operating leases.

Its major recommendations for capital leases (finance leases) are as follows:

For Lessees:

The statement recommended that the lessee must record a capital lease as an asset and as an obligation equal to the present value of minimum lease payments or the fair value of the leased property, whichever is lower.

To compute the present value of the minimum lease payment, the lessee should use the discount rate which is his incremental borrowing rate or the lessors implicit rate of interest, whichever is lower.

The lessee should amortize the asset over its estimated useful life in a manner consistent with the lessee's nominal depreciation policy. During the lease term, each periodic payment should be allocated between a reduction of the obligation and an interest in order to produce a constant periodic rate of interest on the remaining balance of the obligation.

**For Lessor:**

The statement recommended that the lessor should include the gross value after reckoning the minimum lease payment plus the residual value of leased asset in his financial statement.

The difference between the gross investment and its present value should be recognized as unearned income and it should be treated as earned over the life of the lease so as to produce an equal periodic rate of return on the net investment in the lease.
If the lease transaction includes purchase option, the lessor should show the sale price at the present value of the minimum lease payments, deducting from it the cost of sale comprising of the cost of the leased property and the other initial direct cost incidental to the same, less the present value of the residual.

The main recommendations of the FASB – 13 for the operating leases have been given as follows:

For Lessee:

The lessee should show the future minimum rental payment required as on date of the presentation of the balance sheet. He should disclose the rental expenses for the period to which the income statement relates classifying the amount into minimum rentals, consignment rentals etc. If the lease agreement provides the opportunity of sub-lease, the minimum rent from sub-lessee should also be shown.

For Lessor:

The statement recommended that the lessor should show the cost of property on lease as an asset in the balance sheet. This asset must be shown category wise together with the depreciation so far accumulated. Along with the asset the minimum
rental receipt from such lessee in aggregate may also be shown. In his income
statement, the contingent rentals, included in the income, should also be shown.

In addition to these stipulations for capital lessor, FASB – 13 requires the
lessee to disclose more detailed information for both capital and operating leases in
notes.

RECOMMENDATIONS OF INTERNATIONAL ACCOUNTING
STANDARD COMMITTEE : IAS – 17

International Accounting Standard Committee issued a statement "Accounting
for Leases" in September 1982 on the basis of review of comments on 'Exposure
Draft – 29' by IASC in 1981. ²

This statement deals with accounting for leases only and it does not deal with
any other aspect of leasing such as lease agreement and licensing agreement. This
standard also adopted the classification of lease into finance and operating lease.

². Accounting for Leasing, "International Accounting Standard – 17", International Accounting
The major recommendations of the IAS - 17 regarding finance lease are as follows:

**For Lessee:**

For lessee the standard recommends that a finance lease should be reflected in the balance sheet of a lessee by recording an asset and a liability at amounts equal at the inception of the lease to the fair value of the leased property net of grants and tax credits receivable by the lessor or if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments, the discount factor is the interest rate implicit in the lease, if this is practicable to determine. If not, the lessee’s incremental borrowing rate is used.

Rentals should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest of the remaining balance of the liability for each period. Some form of approximation may be used.

A finance lease give rise to a depreciation charge for the asset as well as a finance charge for each accounting period. The depreciation policy for leased assets should be consistent with that of depreciable assets, which are owned. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.
For Lessor:

The main recommendations to account for the financial leases in the books of the lessor are as follows:

An asset held under a finance lease should be recorded in the balance sheet not as property, plant and equipment but as a receivable at an amount equal to the net investment in the lease.

The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either the lessors’ net investment outstanding or the net cash investment outstanding in respect of finance lease. The method used should be applied consistently to leases of a similar financial character.

Manufacturer or dealer should include selling profit or loss in income in accordance with the policy normally followed by the enterprise for outright sales. If artificially low rates or interest are quoted, selling profit should be restricted to that which would apply if a commercial rate of interest was charged. Initial direct costs should be charged to income at the inception of the lease.
For operating lease, the IAS – 17 recommends as follows:

For Lessee:

Under operating leases, the lessee should charge the rental expenses to income in his income statement. The lessee should recognize the rental expenses on a systematic basis that is representative of the time pattern of the user's benefit.

For Lessor:

The statement recommends that the lessor should record the asset on lease as property in the balance sheet. The rental income should be recognized on a straight-line basis over the lease term. The lessor should charge the depreciation on a similar basis consistent with his normal depreciation policy for similar asset.

RECOMMENDATIONS OF ACCOUNTING STANDARD COMMITTEE (ASC) UK : SSAP – 21

SSAP appeared after 11 years of the business of leasing in UK. It was issued in July 1984. The approach in this standard adopted by the ASC is based on the concept of the economic substance and financial reality and not merely on their legal form. This standard also classifies two types of leases: (a) Financial Lease (b) Operating Lease.³

³ Accounting for Leases and Hire Purchase Transactions, “SSAP – 21, Institute of Chartered Accountants of England and Wales, July 1984”.
The main recommendations of SSAP – 21 for finance leases are as follows:

**For Lessee:**

The standard recommends capitalization of finance lease in the books of lessee. The standard allows assets on a finance lease to be depreciated over the shorter of the lease period and the assets estimated working life. The lessee is required to calculate the interest rate implicit in the lease to determine the assets fair value. This method calculates the actual cash flow during the term of lease, allowing for tax credit and interest costs.

**For Lessor:**

For lessor the standard recommends that the amount due from the lessee under a finance lease should be recorded under the head debtor at the amount of the net investment (net of provisions such as bad and doubtful debts). Further, the gross earnings should normally be allocated to accounting periods to give a constant periodic rate of return on the lessors net cash investment in the lease in each period. An allocation may be made first out of gross earnings of an amount equal to the lessors estimated cost of finance included in the net cash investment calculations with the balance being recognized on a systematic basis.
For operating lease, the standard recommends that the operating lease should be dealt with as rental payments in the income statement of lessee. SSAP -21 requires that the commitment to be disclosed should be classified according to the length of the lease.

For lessor, the amount due from the lessee under an operating lease, should be recorded as a property, plant and machinery etc. The asset should be shown as net of depreciation according to the method used by lessor for his other assets. The rental income should also be recognized on a systematic basis.

In addition to the various actuarial approaches to income recognition, the standard makes provision for a relatively new approach – The Investment Period Method (IPM). The IPM allocates gross earnings in proportion to the lessors expected investment in the lease period. The approach was designed to allow for the fact that investment in a lease was approximately halved if a 100 per cent capital allowance is received, so the IPM results in most gross earnings being allocated to the first year or two of the lease, when the lease results in a surplus cash flow to the lessor, no gross earnings are recognized.
In March 1984, the Australian Accounting Profession also moved to regulate financial reporting of lease transactions by the issuance of "Statement of Accounting Standard No. 17", Accounting for Leases.4

The standard consists of three parts. The first part deals with the classification of the leases by the lessors and lessees. The second part of the standard is concerned with accounting for leases by lessees, while the third part is related to accounting for leases by lessors.

The standard also classifies the leases into finance lease and operating lease depending upon economic substance as stated earlier.

The main recommendations of the AAS –17 for finance lease are as follows:

**For Lessee:**

Traditionally, finance leases have been accounted for by lessees in Australia either by treating lease payment as expenses, when incurred with additional footnote

of leased details or as the acquisition of an asset and re-organization of liability at lease commencement. The standard strongly recommends capitalization of leases in the books of the lessee. According to the standard, a lessee is required to record in the accounts an asset representing the right to use the leased property over the term of lease and a liability equal to the future obligations under the lease, net of future interest. The asset then should be depreciated over its useful life and the liability should periodically be reduced as the lease payments are dissected into principal and interest component.

For Lessor:

For lessor, in Australia, it is already a normal practice to account for assets held under finance lease as a receivable amount rather than as property. AAS – 17 requires the receivable to be shown as an amount equal to the lessor's investment in the lease and for lease rentals to be dissected into recoupment of this investment and finance income. The income should be determined on the basis, which yields a constant rate of return on the outstanding balance of the lessor's investment in the lease at the beginning of cash payment period. Further, lessors are required to classify finance leases as direct finance lease, sale type leases or leverage leases.
The recommendations of the AAS – 17 about operating leases are as follows:

**For Lessee:**

For operating leases, the standard recommends to charge lease rentals as expenses in the books of the lessees. The expenses should be charged to income, when incurred.

**For Lessee:**

According to the standard, assets held under operating leases are to be shown in the lessor’s account as the property, plant or equipment actually being leased. The rentals should be treated as income in the income statement.