Leasing is a significant source of finance. Since long it has been used as an important means to finance acquisitions of assets in many countries, including India. The penchant for a pertinent accounting method for leasing transaction that can comply with the stipulations of accrual-based accounting is in vogue in almost all the countries of the world where leasing has graduated into a certain phase of development. The question of lease accounting in the Western countries has been observed predominantly from the perspective of a lessee. In other words, it is viewed from the standpoint of the distortions likely to be caused in the lessee's balance sheet if the assets taken on lease are not disclosed therein. In India, the problem has been perceived chiefly due to the distortions likely to come in the lessor's profit and loss account if the leasing revenue is recognised as per the lease agreement.

Viewed in a broad perspective, the problem has both the aspects—lessor accounting as well as lessee accounting. The accounting problem for the lessor is income recognition, whereas that for the lessee is asset-recording. In other words, a specific method of accounting is necessary for income-recognition for the lessor, and asset disclosure for the lessee. Presently, the question ensues as to why there should be a need for special method of accounting for leases. Such special method is called for in view of the dichotomy in a financial lease which is recorded in the documents as a lease whereas the parties do actually contemplate to exchange a loan for a commitment to pay. Application of the normal method of accounting to record
a leasing transaction may be helpful in rendering this intention non-applicable in the statements made by the lessor and the lessee.

**ACCRUAL ACCOUNTING**

Accrual or mercantile basis is the commonly accepted principle of accounting. In other words, the impact of events on assets and equities is acknowledged in the accounting records in the time periods when services are brought about or utilised instead of when cash is received or disbursed. That is, revenue is recognised as it is earned, and expenses are recognised as they are incurred, not when cash changes hands. Thus an essential exercise in accounts is to spread cash inflows and outflows over the relevant periods. Thus, if cash is spent today to acquire a machine, its charge to revenue is spread to periods depending on the revenue that the asset produces.

Matching is not only a favourite buzzword of accrual-based accounting, but also constitutes its underlying fundamental principle. The process of matching entails the relating of accomplishments (revenues) and efforts (expenses) to a particular period for which a measurement of income is desired. This matching principle together with the accrual basis lies at the bottom of mercantile accounting system. In other words, by the accrual basis, events relating to the period over which they actually generate income, and by the matching principle, the cost pertaining to particular revenue must match the distribution of revenue. It entails that the distribution patterns of the costs and revenues must be uniform.

A number of accounting practices are unveiled by the matching principle. It can be illustrated by the example of Rs. 100 spent on the
purchase of a machine. The cash outflow of Rs. 100 shall be charged not at the time of spending, because that will produce incompatible accounting results. Instead, it shall be amortised over the years corresponding to the revenues occasioned by it. This explains the concept of depreciation. As per the matching principle, depreciation must correspond to the proportions in which the asset yields cash flows. Written down value (WDV) method is usually followed to amortise asset values only on a convenient economic assumption that an asset usually faces geometrically diminishing returns.

DEVELOPMENT OF STANDARDS FOR LEASE ACCOUNTING

Proclivity for accounting for leases has been as ancient as the industry of leasing itself. Certainly, one of the major factors that was counted, as a merit of leasing during its initial stages was that leasing was an off-the-balance-sheet method of financing. In 1840, George Hudson— the Railway king— was vehemently reprimanded by his contemporaries for not disclosing the existence of leasing commitments on the accounts of his railway company. The urgency for an appropriate accounting for leases was perhaps triggered by a realisation of the substance in a capital lease—which was nothing less than a loan taken by the lessee. Failure to disclose long-term lease obligations in the balance sheet had the effect of distorting the true and fair view of the state of affairs of the company.

The first authentic pronouncement on accounting on leases came in 1949 from the Committee on Accounting Procedures of the American Institute of Accountants in a statement entitled 'Disclosure of Long term Leases in Financial Statements of Lessees'. In that statement it was inter alia mentioned:
Where rentals or other obligations under long-term leases are material, disclosures should be made in financial statements or notes thereof:
(a) the amount of annual rentals to be paid with some indication of the periods for which they are payable; and
(b) any other important obligation assumed or guarantee made in connection therewith.¹

The stand taken in 1949 was restated with slight simplifications in 1953 vide Bulletin No.43 of the American Institute of Accountants. Thereafter, Prof. John Myers was commissioned by the American Institute of Certified Public Accountants (AICPA) to prepare Accounting Research Study No.4, ‘Reporting of leases in Financial Statements’ which was published in 1962. Myers, although, suggested that the lease data could be shown in notes to the financial statements, he suggested that such notes should be reserved to give supplementary information, and so, to the extent leases give property rights, these rights and related liabilities should be measured and incorporated in the balance-sheet. Within a decade’s span, the Accounting Principles Board (APB) of the AICPA issued four major opinions and one minor opinion, entitled as follow:

Opinion No.5- “Reporting of leases in financial statements of lessees”.
Opinion No. 7- “Accounting for leases in financial statements of lessors”.
Opinion No. 27- “Accounting for lease transactions by manufacturing or dealer lessors”.
Opinion No. 31- “Disclosure of lease commitments by lessees”.

When the Financial Accounting Standards Board (FASB) succeeded the APB in 1973, accounting for leases topped its list of priorities. According to one opinion, the Financial Accounting Standards Board (FASB) since its existence, had spent:

...[M]ore time on this topic than any other accounting issue with which it has dealt. Beginning with the issue of Accounting for Leases, Statement of Financial Accounting Standards (SFAS) No.13 in November 1976, the FASB has issued more than a score of Statements of Financial Accounting Standards, Interpretations

¹ Clark, T.M. (1977), "There is no Accounting of Leasing", The Accountant, 20, January, p.79.
and FASB Technical Bulletins on the subject, as well as several exposure drafts of proposed standards that were never adopted.\(^2\)

The Accounting Standards Committee of the UK Institute of Chartered Accountants issued SAAP 21 on Accounting for Leases and Hire Purchase Contracts. Besides, the International Accounting Standards Committee has published IAS-17 on Accounting for Leases.

**CORE OF A FINANCE LEASE**

The differentiation between operating and finance leases is based on a crucial question answer to which lies in the subjective intentions of the parties to the transaction. For instance, did the lessee, while making the leasing decision, make a lease *versus* buy decision? That is, did the lessee conceive of the leasing facility as an alternative to buying the asset or he regarded taking lease as good as buying and so thought of leasing only as an alternative to borrowing? Similarly, what was the lessor's interest in the lease deal? Did he regard his leasing facility as an investment in an asset and regard his rentals as reward for the use of the asset, or for him, investment in the asset was only limited to taking a purchase invoice, and his rentals were just a bare minimum return on a loan given?

The above may apparently make it too complicated and involved to decide whether a lease is a finance lease or operating lease. But practically it is all simple. If the lessor put the money for a fixed return on and of the principal, and neither for any reward nor for any loss, he would understand the transaction as a loan. So also for the lessee. The meaning of a finance lease thereby becomes circular, viz., if its substance is a secured loan, it is a finance lease; if it is a finance lease, its substance is a financing transaction.

\(^2\) Cited in Ibid.
The question of devising any special accounting techniques arises only when the lease is different in substance than its documented form, that is, when it is finance lease. Therefore, the crucial decision is whether a given lease is a finance lease or an operating lease. Viewed in a broad perspective, the distinction between finance and operating leases can be known only based on the subjective intents of the parties. This is largely true. There may, of course, be quantitative ways of getting an indication about the subjective intents. For instance, it may be seen whether the contracted lease payments which are absolute and non-cancellable, return to the lessor his principal as well a certain interest, as in such cases, the intent is normally that of a loan. But one cannot positively say that the return produced by the lease was the return the lessor might have expected on a loan. He might have hoped for a better return than that produced just by the contracted lease payments and so might have depended on uncontracted residual value.

In the same way, no lessee would like normally to go for renting if during the renting term he has to pay the entire asset cost along with interest. The reason for this being that he could as well take a loan and buy the asset. But here again, the criteria cannot lead to an unambiguous conclusion that a lease which charges the whole cost of the asset along with a certain rate of interest is not a true lease, because we one does know whether the lessee was in a position to arrange a loan and at what rate of interest. Hence, there cannot be any definite infallible quantitative technique of distinguishing between leases and loans. This problem may be faced not really in deciding whether a given lease is a finance one or operating one but in the chances of
circumvention of the accounting standards by the possibility of arguments establishing a finance lease to be an operating lease.

Classification of a lease—whether it is a financial lease or operating lease is facilitated by the accounting standards on the basis of subjective substance of the transaction as well as the quantitative tests. The US accounting standard FASB follows different criteria for lessor classification and lessee classification, as analysed below.

INTERNATIONAL ACCOUNTING STANDARD (IAS)-17

A finance lease is defined vide IAS-17 as one that transfers, to a large extent, all the risks and rewards incident to ownership. Title may or may not be eventually transferred. This is quite a subjective definition which perhaps could not be avoided. What are the risks and rewards incident to ownership and when one can say that the same have substantially been transferred is a question of interpretation. It is envisaged in the Para 3 of the IAS-17: “Risks include the possibilities of losses from the capacity or the technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset’s economic life and of gain from appreciation in value or realisation of a residual value.” The IAS-17 provides following examples of situations where the lease should normally be considered a finance lease:

- The lease transfers ownership of the asset at the end of the lease term.
- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, so that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- The lease term is for the major part of the useful life of the asset. Title may or may not eventually be transferred.
The present value at the inception of the lease of the minimum lease payments is greater than or equal to substantially all of the fair value of the leased asset net of grants and tax credits to the lessor at that time. Title may or may not eventually be transferred.

**FAS-13**

Whereas IAS-17 requires an accountant to comprehend the substance of the transaction based upon transfer of rewards and responsibilities, FAS-13 goes by the quantitative criteria which IAS-17 has narrated only as examples. Apart from this, another significant difference in IAS-17 and FAS-13 is that whereas IAS-17 specifically provides that a lease classified as a capital lease for the lessor should also be treated as capital lease for the lessee on account of consistency of treatment (Para 4), FAS-13 puts certain additional conditions to be scrutinised from the lessor's point of view for a capital lease (same as finance lease), whereby a lease may be a capital lease for the lessee but may not be so for the lessor. The FAS conditions are as follow:

i) The lease transfers the ownership of the property at the end of the lease term.

ii) The lease contains a bargain purchase option.

iii) The lease term is equal to at least 74 per cent of the asset's economic life.

iv) The present value of minimum lease payments is at least equal to 90 per cent of the fair market value of the property reduced by ITC retained by the lessor. The lessor's discounting rate is the IRR of the lease ignoring the guaranteed residual value, and the discounting rate for the lessee is his incremental borrowing rate.

From the point of view of the lessor, the two additional conditions to be satisfied are:

a) Collectibility of the lease payments is reasonably predictable. That is, the rentals are not contingent upon happening of an unpredictable event.

b) No important uncertainties surround the amount of unreimbursible costs yet to be incurred by the lessor. For example, if the lessor undertakes to provide servicing for the equipment, the cost to be incurred on the account is
surrounded by uncertainties. So this may be a good case for the lease being classified as operating lease by the lessor.

A capital lease could either be a sales-type lease or a financing lease. It is said to be sales type lease normally when a manufacturer or dealer uses leasing as a means of marketing the products. In that case, it is said to be sales type if the fair-market value of the property is more than the cost of the lessor. That is, if the normal selling price at an arm's length transaction of the property is more than the lessor's cost, it is apparent that a profit on sale is being made even by leasing out the asset. If the capital lease is not a sales type lease, it is classified as financing lease, where again it may either be direct financing or may be leveraged. Leveraged financing leases have a different accounting treatment.

THE SUBSTANCE TEST

The basic distinction criteria underlying almost all accounting standards is the substance test, that is, a lease transferring substantially all the risks and rewards of ownership is to be regarded as finance lease. The earliest idea of this notion was given by the Accounting Principles Board of AICPA in 1964 in its publication APB-5, where it characterised a capital lease as one where "terms of the lease result in the creation of a material equity in the property."

A lessee should be regarded as being put in a position of beneficial ownership if he is to exclude everybody from enjoying the benefits of commercial exploitation of the asset, and he has also excluded everybody else in suffering the risks involved in the use of the asset. The various benefits of ownership *inter alia* include: i) right of the user of the asset; ii) right to exclusively enjoy any appreciation in the value of the asset; iii) right to prohibit anybody else from using the asset or sharing the benefits of appreciation; iv)
right to prohibit anybody from transferring the asset; v) right to claim damages, warranties etc., from the supplier; vi) right to claim any subsidies or other benefits or concessions attached to ownership of the assets, etc. The risks of ownership *inter alia* include: a) loss due to idle capacity; b) loss due to technical obsolescence of the asset; c) loss due to the asset not being fit for the purpose or merchantable; d) loss due to loss or damages in transit; e) loss due to loss or damage during installation or operation; f) liability to pay any taxes attaching to ownership of the asset; g) liability due to any statutory offences committed because of ownership, use or operation of the asset.

A financial lease would, either expressly or by implication, either, by agreement or by understanding, transfer all such risks and benefits to the lessee only. In other words, the substance of the deal is not an issue to be decided by technicalities and law-in-fact, the very concept, involves transcending the apparent technicalities to look to the real content.

**THE FULL PAYMENTS TEST**

One of the quantitative tests is to see whether the minimum lease payments together with the guaranteed or assured value equal the whole of the asset price in present value terms. That is, if the lessor recovers the whole of asset cost together with interest, the lease is regarded as a financial lease. In fact, every lessor, or nay, every investor will attempt to realise his outlay along with the cost of money. But whereas in a financial lease the lessor realises the whole amount from one lessee, the basic concept of plain hiring involves realising the very amount from a series of lessees. Again, this is only one of the indications, and not a surest test of the substance of the lease. Say, if a transporter operates a fleet of vehicles on contract basis for a
company, and in the course of his contracted term, recovers the whole of his capital cost, operating expenses and interest, it does not mean he has in substance sold the fleet to the company. Other surrounding factors, such as services added to hiring, gain from appreciation etc., have also to be looked at. But normally no lessee would pay the whole of the cost of the asset and still be hirer only.

There may, however, be a gap between the lessor's discounting rate, so that what is regarded as full cost for the lessor is not reimbursement of the full cost for the lessee. The International Accounting Standard laying down the minimum payments test has specified that the present value of the minimum lease payments should be commuted at the interest rate implicit in the lease or the lessee's incremental borrowing rate. To compute the present value of the lease payments at the interest rate implicit in the lease (IRR) and then to see if such present value is 90 per cent or more of the asset cost is to fall into a circular trap, because the IRR by definition is that rate which equates the present value of lease payments with the asset cost. Thus, the only reasonable basis to determine the present value is by using the lessee's incremental borrowing rate, because the full payout feature of the lease is more relevant from the lessee's point of view than that of the lessor. The incremental borrowing rate means the rate at which the lessee has the immediate opportunity to enjoy another lease, or borrow on security for similar term, that is, the available opportunity rate for the lessee.

Quantitatively, if the minimum lease payments together with covenanted residual value pay back 90 per cent or more of the asset cost, then, unless there are other factors repugning that conclusion, the lessee may
be supposed to have entered into a financial lease. In other words, the lessor's asset-based risk must be more than 10 per cent of the asset - if 90 per cent or more of his risk is reposed in the lessee rather than in the asset, the lease deal shall be regarded as a lending transaction.

**TRANSFER OF TITLE TEST**

If the lease transfers the legal title to the lessee either automatically or as an option which is sure to be exercised, the lease is at best regarded as a 'sale' at its very inception, because all that the parties have done is to document a sale today, but delay its fructification till sometime in future. Most of the accounting standards, except those that make no distinction between lease and hire-purchase, would classify a lease with an option to buy as hire-purchase or capital lease. In some countries, any lease with a purchase option is regarded as a capital lease, whereas the IAS, SFAS and SSAP regard a lease as finance lease only if the option to buy is at a bargain price, i.e., price sufficiently lower than the fair value of the residual, so that it becomes reasonably sure that the option shall be exercised.

In India, where even the income-tax laws treat leases with an option to buy as hire-purchase, it is uncommon to find leases giving an option to buy directly. But indirectly or by conduct, such an option is given almost universally. In all such cases where the lease, or a party associated with the lessee in a way that the lessee continues to derive the benefit of the use of the asset, is given either an option to buy or option to sell the asset and retain its residual, or by paying a certain penalty the lessee is absolved from the duty of returning the asset, an option to buy should be deemed to exist. Such an option may be deemed to exist even by past conduct.
METHODS OF ACCOUNTING FOR LEASES

The methods of accounting as prescribed and followed in different countries, including India, mostly comprise finance method, operating method and hybrid method. The Finance method is applicable in the countries following accounting standards similar to the SFAS-13 and IAS-17 to all finance leases. Operating method is applicable in countries pursuing accounting standards similar to SFAS-13 and IAS-17 to all operating leases. In countries which do not subscribe to IAS or SFAS, this method is used for recording all types of leases. Hybrid method is used for recording finance leases and some countries follow this method. It is worth mentioning here that the allocation of rentals between principal and interest constitutes the fundamental concept underlying both the hybrid and financing methods. Hence it needs a brief appraisal.

ALLOCATION OF RENTALS TO PRINCIPAL AND INTEREST

The central issue of the financing method as also of the hybrid method is to dissect the rentals into two components—principal and interest. Such dissection is possible only in a financial lease, because in a true lease or operating lease, the rentals consist of several other elements like charges for services, risk of obsolescence or effort involved in keeping the asset used etc. but in a finance lease, by its very definition, the lessor keeps his stake limited to the financing involved. So the rentals cannot be thought of producing to him anything apart from interest. Further the whole of the rentals are definitely not income, since the lessor loses his investment in the process of earning the same. So, the rentals can comprise of only two elements— an amortisation of
the investment made by him, which is returned in no way other than the rentals, and the return on his advance, that is, his interest.

There are following three ways of making this dissection:

a) *Straight Line Method*

The most simplistic way of looking at the problem is the traditional add on rate method. Under this calculation, the total interest over the period is the difference between the lease rentals and the lessor's investment. This can be termed as total finance charges. These finance charges are assumed to be spread evenly over the lease term. The balance is regarded as principal recovery. However, this method cannot take care of any structuring of the lease rentals, as the interest every year remains the same. Besides, the straight line or add-on rate should never be applied to ascertain the interest inherent in the rentals.

b) *Sum of Digits Method*

The main drawback of the add-on approach which makes it unfit for any meaningful use is that it fails to take care of the declining investment. A proper distribution of the finance charges over period must take is of the fact that the investment declines with each repayment. So, in apportioning interest, the weightages should more in the initial years and go declining in successive years. A rough way of approximating these weightages is the number of instalments outstanding when any payment is made. The sum of digits method is also called the rule-of-78 method, the name derived from the sum of the outstanding instalments in a twelve-month annuity. The sum of digits method is only a crude although simple method of apportioning finance
charges. It fails to exactly identify the interest featuring the rentals. It suffers from following drawbacks:

- It fails to establish the interest rate at which interest is hidden in the rentals;
- The interest element bears a fixed proportion to the amount of principal outstanding, not to the instalments. The method apportions interest on weightages of the instalments outstanding, which cannot give accurate result;
- The method will not be easily applicable when the payments are made in advance. In that case, the last payment will be regarded as consisting wholly of principal, which may not be compatible with the accounting practices;
- The method cannot take care of such non-income receipts as security deposits, which are as much a part of the financial flows.

c) The Actuarial or IRR Method

The only exact way of differentiating the rentals between interest and principal is to find out the exact rate at which interest element is involved in the rentals and then apply the rate to the outstanding principal. The interest rate in-built in the rentals is the implicit rate of return (IRR). The actuarial method involves the establishment of the IRR and applying the same on the outstanding principal at the time of receiving each payment.

THE FINANCE METHOD OF LEASE ACCOUNTING

It is widely recognised that the IAS-17, FAS-13, SSAP-21 etc., require finance leases to be accounted for under the popularly known finance method according to which the lease is reckoned as a financing transaction. As the lessee derives an equitable ownership in the asset at the very inception of the lease, he must capitalise the asset on his balance-sheet. In order to distinguish the assets taken on lease from other assets of the lessee, which distinction is important, as lessee is yet not the perfect owner of the leased assets, the leased asset may be shown separately. Parallel to the acquisition of the asset, there is also a long-term liability to the lessor in form of
contracted rental payments. The lessee must depreciate the leased asset as per his normal depreciation policy, and so he cannot take the aggregate rentals to the debit of his profit and loss account. As a lease is considered akin to a loan, so are the lease payments considered of comprising both interest and principal elements. Thus, the lessee shall charge only the interest element, which is his expense, truly speaking. The lessor shall be deemed to have given a loan equal to the cost of the equipment. His receipts, viz., rentals comprise in part of the reduction of this loan and partly of interest on the loan. He would recognise as his income only the interest thread woven in the rentals.

Basically, there are three aspects involved in lessee accounting—determination of the value to be capitalised or capitalisation value, allocation of finance charges and writing off depreciation. These are briefly appraised here.

a) Capitalisation Value: The IAS-17 provides that the lease shall be capitalised in the lessee's balance-sheet at the lower of the fair market value of the asset or the present value of the minimum lease payments. The present value of the minimum lease payments, that is, excluding those which are contingent, shall be computed at the interest rate implicit in the lease, and if that is impracticable to be determined, then the lessee's incremental borrowing rate shall be used. One can discern the circular nature of this provision. In fact the lease shall be capitalised only at the lessor's net investment or the cost of the asset, because that by definition equals the present value of the minimum lease payments. Of course, the lessee may not be made aware of either of the two facts, viz., the cost of the asset as also the
implicit interest rate (one being known, the other can be computed) which is quite probable in a finance lease. Then only the question of recording the lease at the present value using incremental borrowings rate of the lessee arises.

The net investment is net of grants and tax credits. 'Grants' include any subsidy, etc., if received by the lessor. However, tax credits, viz., investment allowance, etc., need not be deducted from the cost of the asset to find out net investment. The reason is that the implicit rate of return is computed here on pre-tax basis and so tax-benefits or losses are not being considered at all. In any case, the capitalisation should not be in excess of the fair value of the leased asset. Corresponding to the asset, a liability equal to the present value of the lease payments shall be recorded on the liability side. This liability reduces every time the lease payments are made.

b) Allocation of Finance Charges: There are three possible ways of apportioning the finance charges, that is, the difference between the sum total of lease rentals and the asset cost over the period of the lease. The IAS-17 [Para 17] requires that the finance charge should be allocated to periods so as to produce a constant periodic rate of return, the straight-line allocation is summarily rejected. Even the sum of digits method does not produce the same rate of return for every period- the interest is typically higher in proportion to the outstanding capital recovery in the start, and goes declining towards the end. The constant rate of return is produced only by the IRR method. So, the IAS-17 requires finance charges to be allocated following the IRR method.
c) Writing Off Depreciation: the lessee should depreciate the leased asset as per the normal depreciation policy. However, if it is not certain that the asset will be passed on to the lessee at the end of the lease term, the depreciation period should be the shorter of the lease period and the asset's economic life.

DISCLOSURE

The manner of disclosure, as envisaged in the IAS-17, is as follow:

i) The assets acquired under finance leases should be classified by the type of the assets and shown along with other assets of the lessee company. SSAP-21, however, prefers a separate disclosure of assets acquired under a lease under a heading called 'Rights under Finance Leases'.

ii) Obligations, representing the aggregate rentals payable to the lessor, less, of course, unmatured finance charges, should be shown as Creditors. The IAS requires that the amount payable should be analysed as payable within one year and later.

iii) Depreciation and finance charges should be shown under their respective headings.

iv) The accounting policy for capitalising the lease, depreciation and allocation of finance charges should be disclosed. Other information to the lease contract which is significant to the users of financial information like nature of any contingent rental, contingent liability or financial covenants of restrictive nature, which may arise at the end of the lease term should be disclosed.

THE HYBRID METHOD OF LEASE ACCOUNTING

The hybrid method of lease accounting is followed in countries like France, Iran, Malaysia, Philippines, Sweden, Venezuela, etc. The ICAI has recommended this method in India in an attempt to combine the legal treatment as also the financial reality. The objective has been to avoid conflict with the common law and the tax statutes. Accordingly, the lessor is permitted to capitalise the asset, and the lessee must disclose the assets taken on lease by way of note to its accounts. The lessor may take the rentals to his income, but should charge depreciation in a way that the post-resultant depreciation profit is equal to the finance charges under the financing method.
The hybrid method is doing conveniently well in many of the countries where
the leasing has not come to a very advanced stage or where the tax
authorities have not accepted the dichotomy between the accounting
treatment and the tax treatment.

ICAi'S ACCOUNTING STANDARD (AS) 19: AN APPRAISAL

With a view to establish sound accounting practices in leasing industry
in India, the Research Committee of the Institute of Chartered Accountants of
India (ICAI), prepared a Draft of a Guidance Note on Accounting on Leases in
October 1986. Following its approval by the Executive Council of the ICAI in
December 1987, the draft was published in Institute's journal the Chartered
Accountant in February 1987 for comments. On the basis of representations
received from and meetings with representatives of the leasing industry, the
Guidance Note was substantially modified. The earlier Draft was based mostly
on the IAS-17 and provided the leases to be capitalised by the lessee- the
hybrid treatment given only as an interim measure to avoid conflict with tax
laws. The new modified Guidance Note, although still described as an interim
measure and not precluding the recording of leases as per IAS-17, had
dropped the part prescribing the substance of finance leases as loan on
security, and recommended the hybrid method. However, the operation of the
Guidance Note on Lease Accounting 1988 was stayed by the Madras High
Court in the case of ASSOCIATION OF LEASING & HOUSING FINANCE
COMPANIES Vs. THE INSTITUTE OF CHARTRED ACCOUNTANTS OF
INDIA in April 1990.

Subsequently, the ICAI issued the revised version of the Guidance
Note in 1995. The accounting treatment as recommended in the 1995
Guidance Note, specifically pertaining to asset and liability recognition relating to finance leases, was not in accordance with the corresponding International Accounting Standard (IAS) 17 on Accounting for Leases. However, the Guidance Note did not preclude accounting for lease transactions in accordance with IAS 17 till the issuance of an accounting standard by ICAI. In 2001, an accounting standard, namely, AS 19, Leases, was issued by ICAI to deal with the subject. This standard is based on IAS 17, ‘Leases’ as revised in 1997.

The Accounting Standard (AS) 19 came into effect in respect of all assets during accounting periods commencing on or after 1 April 2001, is a mandatory in nature from that date. Accordingly, the ‘Guidance Note on Accounting for Leases 1995’, is no more applicable in respect of such assets. In terms of AS 19, classification of leases is facilitated into two types—finance leases and operating leases. This classification is significant because the accounting treatment for a lease is determined by its classification. The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relations to finance leases and operating leases.

Paragraph 1 of AS-19 stipulates that it would be applicable in accounting for all leases other than:

- lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and
- licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- lease agreements to use lands.

AS-19 is applicable to agreements that facilitate transfer of the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Or, the other
hand, this Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. Take the example of an agreement between a purchaser and a seller providing for the purchaser that he would pay specified amounts periodically in return for products and services. It entails that the purchaser must make specified minimum periodical payments even if he does not obtain the products or services as envisaged in the agreement.

In the present case the purchaser receives the goods or services but does not enjoy the exclusive right to use the assets utilised to produce the goods or provide the services. Under AS-19 a lease is defined as “an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.” In the above-mentioned example, since the purchaser is not entitled to make use of the assets utilised to produce the goods or provide the services, and the only interest of the purchaser is to obtain the goods or services, such an agreement would not fall within the purview of AS-19.

Take another instance where the purchaser wields effective control over the assets used to produce the goods or provide the services. In this case if the agreement between the purchaser and seller contains the provision that the purchaser would have the right to use the asset for a fixed amount of fee, it may construed to be a lease. The fact that it is not mentioned as a lease in the agreement is irrelevant in this case. Consequently, the certainty of whether an agreement is a lease agreement or not is a matter of judgement based on the substance of the agreement. Hence, there is a need
to carefully scrutinise the terms of an agreement in order to assess whether they fall within the ambit of AS-19.

DEFINITIONS OF KEY TERMS

Definitions of key terms used in the AS-19 in their elaborated form are as follow:

- A **lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. This definition encompasses agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These agreements are generally known hire-purchase agreements. Hire-purchase agreements embody agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

- A **finance lease** is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

- An **operating lease** is a lease other than a finance lease.

- The **inception of the lease** is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease. For the purpose of this definition, a commitment would usually be in writing, signed by the parties to the transaction, and would specifically set forth the principal provisions of transaction. If any of the principal
provisions are yet to be negotiated, then such commitment may fail to qualify for this definition.

- The **lease term** is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

- A **non-cancellable lease** is a lease that is cancellable only:
  - upon the occurrence of some remote contingency; or
  - with the permission of the lessor; or
  - if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
  - upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Examples of remote contingency include change in government regulations resulting in cancellation of the lease, destruction of the leased asset due to natural calamity, etc. The remote contingency may or may not be specified in the lease agreement.

Inclusion of significant penal clauses which become applicable if the lessee cancels the lease agreement is also an indicator of a non-cancellable lease.

- **Residual value** of a leased asset is the estimated fair value of the asset at the end of the lease term.

- **Guaranteed residual value** is:
  (a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee, or by party on behalf of the lessee (the
amount of the guarantee being the maximum amount that could, in any event, become payable); and
(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

- **Unguaranteed residual value** of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

- **Minimum lease payments** (MLPs) are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:
  (a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or
  (c) in the case of the lessor, any residual guaranteed to the lessor:
    (i) by or on behalf of the lessee; or
    (ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease is reasonably certain to be exercised, the minimum comprise minimum payments payable over the lease term and the payment required to exercise this purchase option (sometimes referred to as 'bargain purchase option').
In the context of the above definition, a third party could be construed to be independent of the lessor, if it is not controlled or significantly influenced by the lessor or which does not control or exercise significant influence over the lessor.

Examples of determination of the minimum lease payments, as suggested in the AS-19, are as follow:

An independent third party guarantees residual value for a fee which is paid by the lessor.

Such guaranteed residual value would not form part of the minimum lease payments in the case of the lessee, as the said residual value has not been guaranteed on its behalf. As the third party guaranteeing the residual value is doing so in consideration for a fee paid by the lessor, the residual value thus guaranteed would be included in the minimum lease payments for the lessor, provided that the third party is independent and is financially capable of meeting the guarantee. If the fee for providing the guarantee is paid to the third party by the lessee, the residual value guaranteed should be included in both the lessor's and lessee's minimum lease payments since it would be considered as a guarantee on behalf of the lessee.

The lessee's subsidiary or joint venture guarantees the residual value of the leased asset.

Such guaranteed residual value would form part of the lessee's minimum lease payments and that of the lessor as well, since it would be considered as a guarantee on behalf of the lessee.

The lessor's subsidiary/associate/joint venture guarantees the residual value of the leased asset.
The definition of minimum lease payments specifies that only residual values guaranteed (a) by the lessee or on his behalf or (b) by an independent financially capable third party, can be included in the minimum lease payments of the lessor.

Entities that are either controlled or under significant influence of the lessor, can not be considered independent third parties for this purpose.

*Bargain purchase price included in the minimum lease payments*

In case of a bargain purchase option, the purchase price at which such an option is exercisable by the lessee should be included in the minimum lease payments of the lessee as well as the lessor.

For example, A Limited has taken a car on finance lease from XYZ Limited with a lease term of three years. At the end of the lease, A Limited as has the option to purchase the car for Rs 50,000. The fair value of the car at the end of the lease is estimated to be Rs 200,000. It is reasonably certain at the inception of the lease that A Limited would exercise this option. Hence, the bargain purchase price of Rs 50,000 should be included in the minimum lease payments of the lessee as well as that of the lessor.

- Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing partners in an arm's length transaction.

The following are examples of determination of fair value:

- When the lessor is a manufacturer or dealer, the fair value of the leased asset at the inception of the lease is usually the enterprise’s normal selling price for a cash sale, considering any volume or trade discounts that may be applicable. Such determination of fair value
would need to be made in the light of market conditions prevailing at the time of the inception of the lease.

- When the lessor is not a manufacturer or a dealer, the fair value of the leased asset at the inception of the lease could ordinarily be the cost at which the lessor acquired the asset, considering any volume or trade discounts that may be applicable. However, where there has been a significant lapse of time between the acquisition of asset by the lessor and the inception of the lease, the determination of fair value should be in the light of market conditions prevailing at the time of the inception of the lease which may indicate that the fair value of the leased asset is greater or less than its carrying amount.

- Where an active market exists, market value generally provides the best evidence of fair value. An active market is a market where all the following conditions exist:
  (i) the terms traded within the market are homogeneous;
  (ii) willing buyers and sellers can normally be found at any time; and
  (iii) prices are available to the public.

- **Economic life** is either:
  (a) the period over which an asset is expected to be economically usable by one or more users; or
  (b) the number of production or similar units expected to be obtained from the asset by one or more users.

- **Useful life** of a leased asset is either:
(a) the period over which the leased asset is expected to be used by the lessee; or
(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

- **Gross investment in the lease** is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

- **Unearned finance income** is the difference between:
  (a) the gross investment in the lease; and
  (b) the present value of
     (i) the minimum lease payments under a finance lease from the standpoint of the lessor; and
     (ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

- **Net investment in the lease** is the gross investment in the lease less unearned finance income.

- The **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of
  (a) the minimum lease payments under a finance lease from the standpoint of the lessor; or
  (b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

  The definitions of gross investment, net investment, and unearned finance income can be illustrated with the help of following example:
‘A’ Limited transfers a car on finance lease to ‘X’ Limited. The terms of the lease agreement are: Lease term- 3 years; Economic life- 3 years; Fair value- Rs 415,000.

Minimum lease payments Rs 165,000 at the end of 1st and 2nd year and at the end of third year Rs 195,000 (inclusive of guaranteed residual value of Rs 30,000).

Unguaranteed residual value – Rs 40,000

The interest rate implicit in the lease agreement is 16.06 per cent (rounded off to two decimals), as at this rate the aggregate present value of the cashflows is zero as computed below:

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cashflows</td>
<td>-415,000</td>
<td>165,000</td>
<td>165,000</td>
<td>235,000</td>
</tr>
<tr>
<td>Present Value Factor</td>
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<td>0.8616</td>
<td>0.7424</td>
<td>0.6397</td>
</tr>
<tr>
<td>Present value</td>
<td>-415,000</td>
<td>142,170</td>
<td>122,500</td>
<td>150,330</td>
</tr>
</tbody>
</table>

1. This includes unguaranteed residual value of Rs 40,000.

The present value of the unguaranteed residual value is Rs 25,590.

Accordingly,

- Gross investment in the lease = aggregate of MLPs, i.e., Rs 525,000 + unguaranteed residual value of Rs 40,000 = Rs 565,000
- Unearned finance income = Gross Investment in the lease, i.e., Rs 565,000 – PV of MLPs and unguaranteed residual value, i.e., Rs 415,000 (142,170 + 122,500 + 150,330) = Rs 150,000
- Net investment = Rs 565,000 – Rs 150,000 = Rs 415,000 (which is also the fair value of the asset).
• The lessee’s incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

The lessee’s incremental borrowing rate would vary on a case to case basis depending on the lessee’s credit rating, nature of security provided, terms of payment, guarantees provided, volatility of underlying price of the asset etc.

• Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

CLASSIFICATION OF LEASES

A lease can be classified as either a finance lease or an operating lease. As the accounting treatment of a lease is determined by its classification, it is the first for accounting for a lease. For classification of leases into finance and operating, AS-19 defines the terms as follow:

• A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

• An operating lease is a lease other than a finance lease.

Form the above, it may be noted that the classification of leases adopted in the AS-19 is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Title may or may not eventually be transferred.
Risks include the possibilities of losses from the idle capacity or technological obsolescence or variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and gain from appreciation in value or realisation of residual value.

Paragraph 7 of AS-19 states that, "Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometime result in the same lease being classified differently by the lessor and the lessee." Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

Some examples of situations entailing the potential of leading a lease to being classified as a finance lease are given below:

- **The lease transfers ownership of the asset to the lessee by the end of the lease term.**

  Though this is not essential for transferring substantially all the risks and rewards incident to ownership, it is one of the most convincing forms of evidence. The transfer of ownership at the end of the lease term could be either documented in the lease agreement or be the subject of a separate agreement.

- **The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than its fair value at the date the option becomes exercisable such that at the inception of the lease, it is**


reasonably certain the option will be exercised (i.e., a bargain purchases option).

Rather than transferring title to the lessee by the end of the lease term, certain lease agreements may provide the lessee with the option to purchase the asset at a bargain price. Some examples where a bargain purchase option may exist could include lease agreements which specify that:

- the lessee may purchase the asset at the fair value less a significant discount;
- the lessee may purchase asset at the fair value (say estimated at Rs 100), while a separate agreement from the lessor guarantees a payment of an amount in excess of a given value (say Rs 60);
- the lessee can purchase the asset at the fair value, while the lessor agrees to incur significant costs related to the transfer of the asset, that otherwise would have been borne by the lessee on purchase;
- the lessee can purchase the asset at the fair value though the lessor will bear all future maintenance costs related to the asset, which are expected to be substantial, subsequent to its sale.

- The lease term is for the major part of the economic life of the asset even if title is not transferred.

There are no objective thresholds to define 'major part'. What constitutes a major part of the leased asset is a question of judgement. It may be noted that as per the definition of the 'lease term' given in AS-19, "any future periods for which the lessee has option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it
is reasonably certain that the lease will exercise (referred to as ‘bargain renewal option’) form part of the lease term. Accordingly, if the lease has an option to renew the lease at bargain price vis-à-vis high replacement/alternative procurement costs, the further periods for which the lessee has the option would be included as a part of the lease term. Therefore, while determining as to whether the lease term is for the major part of the economic life of the asset or not, the existence of the bargain renewal option should also be considered.

- **At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.**

The above comparison based on present value ensures that due recognition is given to the timing as well as the quantum of cashflows, e.g., a balloon payment received during the later years of a lease receives a sharper discount than a payment received during the earlier years of the lease.

There are no objective thresholds to define ‘substantially’. What constitutes substantially all of the fair value of the leased asset is a question of judgement.

Importantly, it is possible for a lease to be classified as a finance lease in spite of the present value of its minimum lease payments not representing substantially all of the fair value of the leased asset, if there are other criteria which indicate a transfer of substantially all the risks and rewards incident t ownership.
The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made. Examples of such assets could include power plants, boilers and similar industrial equipment, which are not easily replaceable and cannot be used by another party without major modifications. The functioning of such equipment is usually linked intrinsically to continuity of the lessee's business activities. Consequently, replacement of such equipment is a complicated and expensive endeavour which is not usually resorted to during the asset's economic life. In such a situation, it may be appropriate to conclude that the lessee would use the asset for its future economic life, and has thereby acquired substantially all the risks and rewards incident to the ownership of such assets.

Indicators of situations which individually or in combination could so lead to a lease being classified as a finance lease are as follow:

1. Where the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

   This could include large payment penalty charges which is adequate to compensate the lessor for the loss on sale of the asset or interest differential on entering into a fresh lease at current market rates.

2. The gains or losses from the fluctuations in the fair value of the residual value of the leased asset fall to the lessee.

   For example, a lease where the lessee has to reimburse the lessor for any loss and gets the gains on fluctuations in the fair value of the residual value of leased asset.
- The lessee has the option to continue the lease for a secondary period at a rent which is substantially lower than the market rent.

While evaluating this indicator at the time of lease classification, one should bear in mind that sometimes lease renewals involve hidden costs like environment clean-up charges, taxes and levies etc., which the lessor may agree to pay which, otherwise, would have been borne by the lessee. Such a situation may construe to be similar to the one in which the lessor charges lower than market rent during the secondary period of the lease.

DATE OF CLASSIFICATION

As per paragraph 10 of the AS-19, lease is classified at the inception of the lease. If, at any time, the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria discussed above, had the changed terms been in effect at the inception of the lease, the revised agreement is considered at a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes. The changes in estimates would require to be accounted for and disclosed in accordance with AS-5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

ACCOUNTING OF A FINANCE LEASE IN THE FINANCIAL STATEMENTS OF A LESSEE

While the legal form of a lease agreement, in the case of finance lease, is that the lessee may not acquire any legal title to the leased asset, the
substance and financial reality are that the lessee assumes significant risks and rewards incident to the ownership of the leased asset. In view of the principle of 'substance over form', it is appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. Accordingly, the following should be the accounting treatment for a finance lease in the financial statements of a lessee:

(i) At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability.

(ii) Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value exceeds the present value of the minimum lease payments (MLPs) from the standpoint of lessee, the amount recorded as an asset and a liability should be the present value of the MLPs from the standpoint of the lease.

(iii) In calculating the present value of MLPs, the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

(iv) The above-mentioned asset and liability for the future lease payments are recognised in the balance sheet at the same amounts at the inception of the lease.
The liability for a leased asset should not be netted-off from the leased asset, but should be presented separately in the balance sheet as a current liability or a long-term liability, as the case may be.

Typically, in the case of a finance lease, liability of the lessee is against the security of the asset taken on lease (as the lessor retains the legal title). There may or may not be additional security provided to the lessor. Accordingly, for a company, the finance lease liability could be disclosed under the head 'Secured Loans' in the balance sheet as 'Finance Lease Obligations'. Further, other relevant disclosures under Schedule VI to the Companies Act, 1956, including the nature of security provided would also need to be made. Initial direct costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease. Initial costs that are directly attributable to activities performed by a lessee for a finance lease are typically those costs that would have been avoided if the decision to acquire assets on finance lease had not been made. These would include costs like commissions, legal fees and other costs associated with negotiating and consummating leasing transactions etc.

As per paragraph 16 of AS-19, "Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated for periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period." Further, as per paragraph 18 of AS-19, a finance lease gives rise to a depreciation expense for each accounting
period. Based on the above, the accounting for a finance lease in the books of the lessee in respect of the finance charge and depreciation is as follows:

(i) By applying the discount rate arrived at as explained above to the amount of liability in respect of the lease outstanding at the beginning of the period, the finance charge of the period should be determined.

(ii) The finance charge for the period determined as per (i) above should be reduced from the lease payment made for the period.

(iii) The amount of lease payment as reduced by the finance charge (compounded as per (ii) above) should be reduced from the opening balance of the outstanding liability in respect of the lease.

(iv) The finance charge for the period as per (i) above should be charged to the statement of profit and loss, unless it is considered as a borrowing cost directly attributable to acquisition, construction or production of a qualifying asset.

(v) Depreciation for the period on the asset obtained under a finance lease should be charged to the relevant statement of profit and loss.

The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation amount should be arrived at on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee would obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, which ever is shorter. It may
be noted that AS-6, 'Depreciation Accounting', stands withdrawn with respect to amortisation (depreciation) of intangible assets from the date AS-26, 'Intangible Assets', becomes mandatory for the concerned enterprises. Accordingly, leased intangible assets should be amortised, as per the provisions of AS-26, from the date it becomes mandatory for the concerned enterprises. Paragraph 21 of AS-19 alludes to the Accounting Standard dealing with impairment of assets (AS-28, 'Impairment of Assets') to determine whether a leased asset is impaired. AS-28 sets out the requirements as to how an enterprise should review the carrying amount of an amount of an asset, how it should determine the recoverable amount of the asset and when it should recognise, or reverse, an impairment loss.

DISCLOSURE REQUIREMENTS

In addition to the requirements of AS-10, Accounting for Fixed Assets; AS-6, Depreciation Accounting; and the governing statute, paragraph 22 of AS-19 requires lessees to make the following disclosures for finance leases:

(a) assets required under finance lease as segregated from the assets owned;

(b) for each class of assets, the net carrying amount at the balance sheet date;

(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date and their present value, for each of the following period:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;
(d) contingent rents recognised as expense in the statement of profit and loss for the period;

(e) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;
(ii) the existence and terms of renewal or purchase options and escalation clauses; and
(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

In addition to the above, disclosure requirements under AS-26 (in respect of leased intangible assets) and AS-28 are applicable from the date the respective standards become mandatory.

ACCOUNTING FOR AN OPERATING LEASE IN THE FINANCIAL STATEMENTS OF A LESSEE

Lease payments, excluding costs for services such as insurance and maintenance, under an operating lease, should be recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis. For example, in the case of manufacturing equipment taken on operating lease, the recognition of lease payments may be based on machine hours used, units produced or capacity utilised.

DISCLOSURE REQUIREMENTS

As per paragraph 25 of AS-19, the lessee should make the following disclosures for operating leases:
(a) the total of minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;
(ii) later than one year and later than five years;
(iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;
(ii) the existence and terms of renewal of purchase options and escalation clauses; and
(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

ACCOUNTING FOR A FINANCE LEASE IN THE FINANCIAL STATEMENTS OF A LESSOR

As per paragraph 26 of AS-19, "The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease." Further, paragraph 28 of AS-19 states that, "The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease." It is stipulated under paragraph 30 of AS-19 that regular review of estimated unguaranteed residual values used in computing the lessor's gross investment in a lease. If there has a
reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value are accounted for as a change in accounting estimate and disclosed as per the requirements of AS-5, 'Net Profit and Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

Lessors, in negotiating and arranging a lease, often incur initial indirect costs, such as commissions and legal fees. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

FINANCE LEASES BY MANUFACTURERS OR DEALERS

Manufacturers or dealers frequently offer to customers the choice of either buying or leasing an asset. A finance lease of an asset given by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

To appropriately account for such leases, paragraph 33 of AS-19, inter alia, states: "The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged." Such
accounting is achieved by recording at the commencement of a finance lease term:

- Sales revenue equal to the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed.

- Cost of sale equal to the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value.

- The difference between the sales revenue and the cost of the sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

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 an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest were quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged. The commercial rate of interest referred to above could be construed to be the rate at which the lessor or any other entity would provide lease finance for a similar asset with a minimum credit profile on similar terms. As per paragraph 32 of AS-19, "Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease." This is based on the premise that such costs mainly relate to earning the manufacturer's or dealer's selling profit.
DISCLOSURE REQUIREMENTS

Paragraph 37 of AS-19 requires lessors to make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;
(ii) later than one year and later than five years;
(iii) later that five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;

(d) the accumulated provision for uncollectable minimum lease payments receivable;

(e) contingent rents recognised in the statement of profit and loss for the period;

(f) a general description of the significant leasing arrangements of the lessor; and

(g) accounting policy adopted in respect of initial direct costs.

Paragraph 38 of AS-19 states that, "As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases."
ACCOUNTING FOR AN OPERATING LEASE IN THE FINANCIAL STATEMENTS OF A LESSOR

As per paragraph 39 of AS-19, "The lessor should present an asset given under operating lease in its balance sheet under fixed assets." Further, lease income (excluding receipts for services provided such as insurance and maintenance) from operating leases should be recognised in the statement of profit and loss 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 in which benefit derived from the use of the leased asset is diminished." Thus, income from operating leases should not be recognised necessarily on the basis of the repayment schedule, without reference to the time pattern in which benefit derived from the use of leased asset is diminished. As per paragraph 45 of AS-19, a manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

The costs, including depreciation, incurred in earning the lease income should be recognised as an expense. As per paragraph 43 of AS-19, "The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for the similar assets, and the depreciation charge should be calculated on the basis set out in AS-6, Depreciation Accounting." It may be noted that AS-6 stands withdrawn with respect to the amortisation (depreciation) of intangible assets from the date AS-26, 'Intangible Assets', becomes mandatory for the concerned enterprises. Accordingly, leased intangible assets should be amortised, as per the provisions of AS-26, from the date it becomes mandatory for the concerned enterprises.
Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rental income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. Paragraph 44 of AS-19 draws reference to the Accounting Standard dealing with impairment of assets (AS-28, 'Impairment of Assets') to determine whether a leased asset is impaired. AS-28 sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

**DISCLOSURE REQUIREMENTS**

As per paragraph 46 of AS-19, the lessor should, in addition to the requirements of AS-6, 'Depreciation Accounting', and AS-10, 'Accounting for Fixed Assets', and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

(i) the depreciation recognised in the statement of profit and loss for the period;
(ii) impairment losses recognised in the statement of profit and loss for the period;
(iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

(i) not later than one year;
(ii) later than one year and not later than five years;
(iii) later than five years;
(c) total contingent rents recognised as income in the statement of profit
and loss for the period;
(d) a general description of the lessor's significant leasing arrangements;
and
(e) accounting policy adopted in respect of initial direct costs.

In addition to the above, disclosure requirements under As-26 (in
respect of leased intangible assets) and AS-28 are applicable from the date
the respective standards become mandatory.

**Sale and Leaseback Transactions**

A sale and leaseback transaction involves the sale of an asset by the
vendor and leasing of the same asset back to the vendor. This can be
illustrated as follow:

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Transfers ownership of asset to

Seller/Lessee a Buyer/ Lessor

Leases back the asset to
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In the sale and leaseback arrangement, the lease payments and the
sale price are usually interdependent as they are negotiated as a package.
The accounting treatment of a sale and leaseback transaction depends upon
the type of lease involved.

As per paragraph 48 of AS-19, "If a sale and leaseback transaction
results in a finance lease, any excess or deficiency of sales proceeds over the
carrying amount should not be immediately recognised as income or loss in the financial statements of a seller/lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset." Paragraph 50 of AS-19 envisages that, "If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale value is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Paragraph 52 of AS-19 states that, "For operating leases, if the fair value at the time of sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately." For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets, viz., AS-28, 'Impairment of Assets'.

The appendix to AS-19 contains a table, as reproduced below, showing the requirements in respect of sale and leaseback transactions that result in operating leases:
<table>
<thead>
<tr>
<th>Sale price established at fair value (paragraph 50)</th>
<th>Carrying amount equal to fair value</th>
<th>Carrying amount less than fair value</th>
<th>Carrying amount above fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>No profit</td>
<td>Recognise profit immediately</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Loss</td>
<td>No loss</td>
<td>Not applicable</td>
<td>Recognise loss immediately</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sale price below fair value (paragraph 50)</th>
<th>Carrying amount equal to fair value</th>
<th>Carrying amount less than fair value</th>
<th>Carrying amount above fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>No profit</td>
<td>Recognise profit immediately</td>
<td>No profit (note 1)</td>
</tr>
<tr>
<td>Loss not compensated by future lease payments at below market price</td>
<td>Recognise loss immediately</td>
<td>Recognise loss immediately</td>
<td>(note 1)</td>
</tr>
<tr>
<td>Loss compensated by future lease payments at below market price</td>
<td>Defer and amortise loss</td>
<td>Defer and amortise loss</td>
<td>(note 1)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sale price above Fair value (paragraph 50)</th>
<th>Carrying amount equal to fair value</th>
<th>Carrying amount less than fair value</th>
<th>Carrying amount above fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>Defer and amortise profit</td>
<td>Defer and amortise profit</td>
<td>Defer and Amortise profit (note 2)</td>
</tr>
<tr>
<td>Loss</td>
<td>No loss</td>
<td>No loss</td>
<td>(note 1)</td>
</tr>
</tbody>
</table>

Note 1. These parts of the table represent circumstances that would have been dealt with under paragraph 52 of AS-19. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2. The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the
agreement or terms of the sale and leaseback transactions. Further, sale and leaseback transactions may also meet the separate disclosure criteria set out in paragraph 12 of AS-5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', which states that, "When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."

CONCLUSION

It emerges from the foregoing brief appraisal of the accounting policies and practices pertaining to leases that at the international level the lease accounting is governed by the International Accounting Standards, IAS-17 on Accounting for Leases and FAS-13. The analysis takes into account substance test; full payments test and transfer of title test for lease accounting. While appraising methods of accounting for leases, an attempt has been made to analyse allocation of rentals to principal and interest that inter alia includes straight-line method, sum of digits method and the accrual or IRR method. While dealing with the Accounting Standard (AS) 19, as envisaged by the Institute of Chartered Accountants of India (ICAI), which has come into force in May 2003, the appraisal takes into consideration the key definitional terms used in the AS-19, and also dwells on classification of leases as per AS-19 provisions.

While dealing with date of the lease, it is revealed that any revision in the provisions of the lease agreement renders it a new agreement over its revised terms. In its appraisal of accounting for a finance lease in the financial
statements of a lessee, the analysis reveals that the lessee should recognise
the lease both as an asset and a liability. This recognition should be at an
amount equal to the fair value of the leased asset at the inception of the
lease. Disclosure requirements for a lessee are also analysed. The analysis
further proceeds to examine accounting for an operating lease in the financial
statements of a lessee. In its appraisal of accounting for a finance lease in the
financial statements of a lessor, the chapter takes into account finance leases
by manufacturers or dealers as well. An attempt is made to take into
consideration accounting for an operating lease in the financial statements of
a lessor, its disclosure requirements and sale and leaseback transactions. It
can be surmised that with AS-19 having become operational in respect of
leasing in India, leasing industry would thrive smoothly.