EXPOSURE DRAFT

Proposed Guidance Note on Accounting for Leases

Last date for comments: April 15, 1987

Operating Lease a lease other than a finance lease.
Non-Cancellable Lease a lease that is cancellable only:
(a) upon the occurrence of some remote contingency,
(b) with the permission of the lessor, or
(c) if the lessee enters into a new lease for the same or any equivalent asset with the same lessor, or
(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.
Inception of the Lease the earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.
Lease Term the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option at the inception of the lease is reasonably certain that the lessee will exercise.
Minimum Lease Payments the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with:
(a) in the case of lessee, any amounts guaranteed by him or by a party related to him, or
(b) in the case of the lessor, any residual value guaranteed to him by either the lessee or a party related to the lessee or an independent third party financially capable of meeting this guarantee.

However, if 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 minimum lease payments comprise the minimum rental payable over the lease term and the payment required to exercise this purchase option.
Fair Value the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.
Useful Life is either (a) the period over which a depreciable asset is expected to be used by the enterprise; or (b) the number of production (or similar) units expected to be obtained from the asset by the enterprise.
Unguaranteed Residual Value that portion of the residual

Reproduced below is the text of the proposed Guidance Note on Accounting for Leases, issued by the Research Committee of the Institute of Chartered Accountants of India, for public comments. Comments on the draft should be sent to the Technical Director at the Institute's New Delhi Office so as to reach him latest by April 15, 1987.

Introduction
1. This Guidance Note deals with accounting for leases, except for the following specialised types of leases:
(a) Lease agreements to explore for use natural resources, such as oil, gas, timber, metals and other mineral rights.
(b) Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
2. The recommendations in this Guidance Note regarding accounting for leases in the financial statements of lessors and lessees are based primarily on the recommendations contained in the International Accounting Standard 17, Accounting for Leases, provisions of law, viz., the requirements of Schedule VI to the Companies Act, 1956 and other considerations such as the prevailing accounting practices in this regard. Many of the definitions, explanatory paragraphs and recommendations contained in International Accounting Standard 17, Accounting for Leases, have been incorporated to the extent applicable to the Indian situation.

Definitions
3. The following terms are used in this Guidance Note with the meanings specified:
Lease An agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time.
Finance Lease a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

The definition of a lease includes contracts for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions, i.e., hire purchase contracts.

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value of the leased asset (estimated at the inception of the lease), the realisation of which by the lessor is neither assured by the lessor nor is guaranteed solely by a party related to the lessor.

Gross Investment in the Lease  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  the difference between the lessor's gross investment in the lease and its present value.

Net Investment in the Lease  the gross investment in the lease less unearned finance income.

Net Cash Investment  the balance of the cash outflows and inflows in respect of the lease excluding flows relating to insurance, maintenance and similar costs re-chargeable to the lessee. The cash outflows include payments made to acquire the asset, interest and principal on third party financing. Inflows include rental receipts, receipts from residual values, and grants, tax credits and other tax savings or repayments arising from the lease.

Interest Rate Implicit in the Lease  the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments, from the standpoint of the lessor, and (b) the unguaranteed residual value to be equal to the fair value of the leased asset, net of any grants and the credits receivable by the lessor.

Lessee's Incremental Borrowing Rate of Interest  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.

Contingent Rental  a rental 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).

Balloon Payment  a large payment made at a specified time during the lease term with the balance being paid in smaller rentals at other times during that period.

Basic Period  the period of a lease term commonly less than the normal working life of the asset during which the lessor expects to recover the capital cost of the asset, other costs and profit. Also sometimes called 'initial' or 'primary' period.

Secondary Period  the period for which the lease is extended by agreement at the end of the basic period between the lessor and the lessee, generally at a much reduced rental.

Lessor  a person, who under an agreement, conveys to another person (the lessee) the right to use, in return for rent, an asset for an agreed period of time.

Lessee  a person, who under an agreement, obtains from another person (the lessor) the right to use, in return for rent, an asset for an agreed period of time.

Explanation

Classification of Leases

4. The classification of leases adopted in this Guidance Note is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or 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.

5. 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. Normally the two parties will classify the lease in the same way. Nevertheless, the application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by lessor and lessee.

6. Whether a lease is a finance lease or not depends on the substance of the transaction rather than the form of the contract. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Such a lease is normally non-cancellable and secures for the lessor the recovery of his capital, outlay plus a return for the funds invested. Examples of situations where a lease would normally be classified as a finance lease include:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

(b) 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.

(c) The lease term is for the major part of the useful life of the asset. Title may or may not eventually be transferred.

(d) 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.

7. A lease is classified as an operating lease if substantially all the risks and rewards incident to ownership are not transferred.

Principles of Accounting for Leases

8. According to Accounting Standard 1, "Disclosure of Accounting Policies", issued by the Institute of Chartered Accountants of India, the accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases, the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right. If such lease transac-
In the Financial Statements of Lessor

Finance Leases

9. An asset held under a finance lease should be recorded in the balance sheet not as a fixed asset but as a receivable, at an amount equal to the net investment in the lease. Subject to the consideration of prudence, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either the lessee's net investment outstanding or the net cash investment outstanding in respect of the finance lease. The method used should be applied consistently to leases of similar financial character.

10. Disclosure should be made at each balance sheet date of the gross investment in leases reported as finance leases, and the related unearned finance income and unguaranteed residual values of leased assets. Disclosure should also be made of the basis used for allocating income so as to produce a constant periodic rate of return, indicating whether the return relates to the net investment outstanding or the net cash investment outstanding in the lease. If more than one basis is used, the bases should be disclosed.

Operating Leases

11. Assets held under operating leases should be recorded as a fixed asset in the balance sheet of lessors. Rental income should be recognised on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earnings process contained in the lease. The depreciation of leased assets should be on a basis consistent with the lessee's normal depreciation policy for similar assets, and the depreciation charge should be calculated on the basis set out in Accounting Standard 6, Depreciation Accounting.

12. When a significant part of the lessor's business comprises operating leases, the lessor should disclose the amount of assets by each major class of asset together with the related accumulated depreciation at each balance sheet date.

In the Financial Statement of Lessees

Finance Leases

13. 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 fair value of the leased property, net of grants and tax incentives 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.

14. 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 on the remaining balance of the liability for each period.

15. A finance lease gives 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 for depreciable assets which are owned and the depreciation charge should be calculated on the basis set out in Accounting Standard 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.

16. Disclosure should be made of the amount of assets that are the subject of finance leases at each balance sheet date. Liabilities related to these leased assets should be shown separately from other liabilities, differentiating between the current and long-term portions. Commitments for minimum lease payments under finance leases should be disclosed in summary form giving the amounts and the periods in which the payments will become due. Disclosure should also be made of significant financing restrictions, renewal or purchase options, contingent rental and other contingencies arising from leases.

Operating Leases

17. The charge to income under an operating lease should be the rental expense for the accounting period, recognised on a systematic basis that is representative of the time pattern of the user's benefit. Non-cancellable operating leases with a term of more than one year should be disclosed in a summary form giving the amounts and the periods in which the payments will become due. If there is no reasonable certainty that the lessee will obtain ownership by the end of lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.
Incarim Recommendations for Accounting for Leases

19. In India however the predominant prevailing accounting practices, in respect of accounting for leases, are not generally in accordance with the principles described in the above paragraphs. The lessors include the assets leased under finance leases in their balance sheets and charge depreciation thereon apart from recognising the rentals as the terms of agreement of the lease as a credit to the profit and loss account. The lessees do not treat the leased assets as assets in their balance sheet and the rentals are charged to the profit and loss account according to the terms of payment of lease.

19. The aforesaid accounting practices have mainly resulted as a response to the relevant provisions of the Income-tax Act, 1961 regarding permissibility of the depreciation allowance only to the owners of the assets. As such, while the Research Committee recognises the principles set out in paras 8 to 17 above, the following recommendations are made till such circumstances obtain i.e. till the law recognizes the primacy of substance over form in case of lease transactions. In making these recommendations the Research Committee recognises that they do not preclude accounting for lease transactions in accordance with IAS-17, even during the interim period.

Accounting for leases in the books of lessor

Finance Leases

20. 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.

21. Lease rental receivable/received 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, of 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 (calculated as per para 22 below) 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 sections 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

20. 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.

23. 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 payments 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 lessor's gross investment in the lease and its present value).

24. 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 Leases

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

26. Costs, including depreciation, incurred in earning the rental income should be charged to income. 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 earnings process contained in the lease.

27. A leased asset for an operating lease should be depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets.

28. Initial direct costs incurred by lessors in negotiating and arranging the lease should be expensed in the year in which they are incurred.

Disclosure

29. 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 a lessee

Finance Lease

30. A lessee should disclose assets acquired under finance lease separately in his 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 be calculated with respect to the basic lease period. The disclosure 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.

31. Lease rentals should be accounted for on accrual basis over the lease term so as to recognise 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 lease rentals paid over the amount accrued in respect thereof should be treated as prepaid lease rental and vice versa.

Operating Lease

32. Lease rentals under operating lease should be accounted for on the basis described in para 31 above.