Guidance Note on Accounting for Leases

Introduction

1. This Guidance Note deals with accounting for leases, except for the following specialised types of leases:

(a) Lease agreements to explore for or 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.

(c) Hire purchase Agreements as defined under the Hire Purchase Act 1972.*

2. The Council of the Institute of Chartered Accountants of India recognises the need for issuance of an accounting standard on the subject of accounting principles and practices in the leasing industry. The matter is under consideration of the Council, but it is recognised that issuance of such a standard will take some time. It is also recognised that the existing accounting practices in the leasing industry have mainly resulted keeping in view the relevant provisions of the Income-tax Act, 1961, regarding permissibility of the depreciation allowance only to the owners of the assets. In this context, this Guidance Note is being issued only as an interim measure. In making the recommendations in the Guidance Note, the Committee recognised that they do not preclude accounting for lease transactions in accordance with International Accounting Standard—17 (IAS-17) on Accounting for Leases even during the interim period.

DEFINITIONS

3. The following terms are used in this Guidance Note with the meanings specified:

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.

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 under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset.

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,

(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 take on lease the asset together with any further periods for which the lessee has the 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 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 any be reimbursable to the lessor) together with the residual value.

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: In the case of an operating lease either (a) the period over which a fixed 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. In the case of a finance lease, the useful life of the asset is the lease term.

*Accounting for such transactions has to be done according to the generally accepted accounting practices. Such assets are recorded at their cash value in the books of the hirer. Reference may be made to AS-10, Accounting for Fixed Assets, issued by the Institute of Chartered Accountants of India. The hirer is also entitled to depreciation under the Income-tax Act, 1961, on such assets.

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**Residual Value**: Value estimated at the inception of lease, of the leased asset, at the expiry of the lease term.

**Interest Rate Implicit in the Lease**: The discount rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payments, from the standpoint of the lessor, to be equal to the fair value of the leased asset, net of any grants and tax credits receivable by the lessor.

**Gross Investment in the Lease**: The aggregate of the minimum lease payments under a finance lease from the standpoint of 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.

**Explanations**

4. A lease is classified as a finance lease if it secures for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. Such a lease is normally non-cancelable and the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset.

5. A lease is classified as an operating lease if it does not secure for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term.

6. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, 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.

7. Residual value is the value estimated at the inception of lease, of the leased asset, at the expiry of the lease term. Such estimate can be made with reference to the terms of lease agreement, type of the asset, and proportion of the lease period to the life of the asset as per the technical/commercial evaluation and such other considerations. It may be possible for the enterprise to estimate the residual value as a fixed percentage of the value of the asset on the basis of its experience over a period of years.

8. There may be certain situations where the ability to assess the ultimate collection with reasonable certainty is lacking in respect of any lease rental. In such cases, according to the accrual basis of accounting, revenue recognition is postponed to the extent of uncertainty involved and it may be appropriate to recognize revenue, in respect of such rentals, only when it is reasonably certain that the ultimate collection will be made.

**Accounting for Leases in the Books of a Lessor**

**Finance Leases**

9. Assets leased under finance leases 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.

10. Lease rentals (those received and those due but not received) under a finance lease should be shown separately under 'Gross Income' in the profit and loss account of the relevant period.

11. It is appropriate that against the lease rental, a matching annual charge is made to the profit and loss account. This annual lease charge should represent recovery of the net investment/fair value of the leased asset over the lease term. The said charge should be calculated by deducting the finance income for the period (as per para 12 below) from the lease rental for that period. The annual lease charge would comprise (i) minimum statutory depreciation (e.g., as per the Companies Act, 1956) and (ii) lease equalisation charge, where the annual lease charge is more than the minimum statutory depreciation. However, where annual lease charge is less than minimum statutory depreciation, a lease equalisation credit would arise. In this regard the following accounting entries/disclosures should be made:

(a) A separate Lease Equalisation Account should be opened with a corresponding debit or credit to Lease Terminal Adjustment Account, as the case may be.

(b) Lease Equalisation Account should be transferred every year to the Profit and Loss Account and disclosed separately as a deduction from addition to gross value of lease rentals shown under the head "Gross Income".

(c) Statutory depreciation should be shown separately in the profit and loss account.

(d) Credit balance standing in Lease Terminal Adjustment Account at the end of the year should be shown under the head 'Current
The constant periodic rate of return on the lease receivable over the lease term and the fair value of net investment in the lease. This method would ensure the leased asset at the inception of the lease. However, the method of income measurement suggested in this paragraph, is in consonance with the inherent nature of a finance lease.

The above method is illustrated in the Appendix to this Guidance Note.

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1. The finance income for the period should be calculated by applying the interest rate implicit in the lease to the net investment in the lease during the relevant period. This method would ensure recognition of net income in respect of a finance lease at a constant periodic rate of return on the lessor's net investment outstanding in the lease. However, some lessors use a simpler method for calculating the finance income for each of the periods comprising the lease term by apportioning the total finance income from the lease in the ratio of minimum lease payments outstanding during each of the respective periods comprising the lease term. (The total finance income from the lease is the difference between the aggregate minimum lease payments receivable over the lease term and the fair value of the leased asset at the inception of the lease.) This method may be used where the finance income in respect of all individual periods as per this method approximates the finance income for the corresponding periods determined according to the former method. It is however clarified that where this method is used, overdue lease rentals, i.e., lease rentals fallen due but not collected should not be taken into account for determining the amount of minimum lease payments outstanding during each of the respective periods comprising the lease term.

2. 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 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).

14. 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. Similarly, income on account of lease, e.g., management fees, should be recognised in the year in which they accrue.

**Finance Leasing by Manufacturers or Dealers**

15. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset 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, i.e., normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

16. The profit or loss referred to in para 15(a) above should be recognised at the inception of a finance lease by a manufacturer or dealer lessor. The finance income referred to in para 15(b) should be allocated on the basis of paras 10 to 14 above. Assets given on finance lease during the year by a manufacturer or dealer lessor may be shown in the profit and loss account on credit side under the title "Assets given on finance lease transferred to Fixed Assets Account" and disclosed in the balance sheet as suggested in para 9 above.

**Operating Leases**

17. A lease is classified as an operating lease if it does not secure for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. Therefore, the asset should be treated by the lessor as a fixed asset and rentals receivable should be included in income over the lease term.

18. Costs, including depreciation, incurred in earning the rental income should be charged to income. Rental income should normally be recognised on a systematic basis which is representative of the time pattern of the earnings process contained in the lease. In many cases, recognition of rental income on a straight line basis over the lease term would be representative of the time pattern.
19. A leased asset for an operating lease should be depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets.

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

Sale and Leaseback

21. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The rentals and the sale price are usually interdependent as they are negotiated as a package and may not represent fair values.

22. If in the case of a leaseback, the rentals and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is normally recognised immediately. If the sale price is below fair value any profit or loss is recognised immediately, except that, if the loss is compensated by future rentals at below market price, it is deferred and amortized in proportion to the rental payments over the useful life of the asset. If the sale price is above fair value, the excess over fair value is deferred and amortized over the useful life of the asset.

Disclosures

23. Apart from the disclosures recommended in the above paragraphs, the lessor should disclose the accounting policies followed with regard to accounting for income under finance lease, valuation of assets given on lease and charge for depreciation.

ACCOUNTING FOR LEASES IN THE BOOKS OF A LESSEE

Finance Leases

24. A lessee should disclose assets taken under a finance lease by way of a note to the accounts, disclosing, inter alia, the future obligations of the lessee as per the agreement.

25. Lease rentals should be accounted for on an 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. The appropriate charge should be worked out with reference to the terms of the lease agreement, type of the asset, proportion of the lease period to the life of the asset as per the technical/commercial evaluation and such other considerations. 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

26. 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.

EFFECTIVE DATE

27. This Guidance Note is recommended for application in respect of lease transactions entered into in the accounting period beginning on or after 1st April, 1989.