UNIT 5: ACCOUNTING STANDARD 19 LEASES

LEARNING OUTCOMES

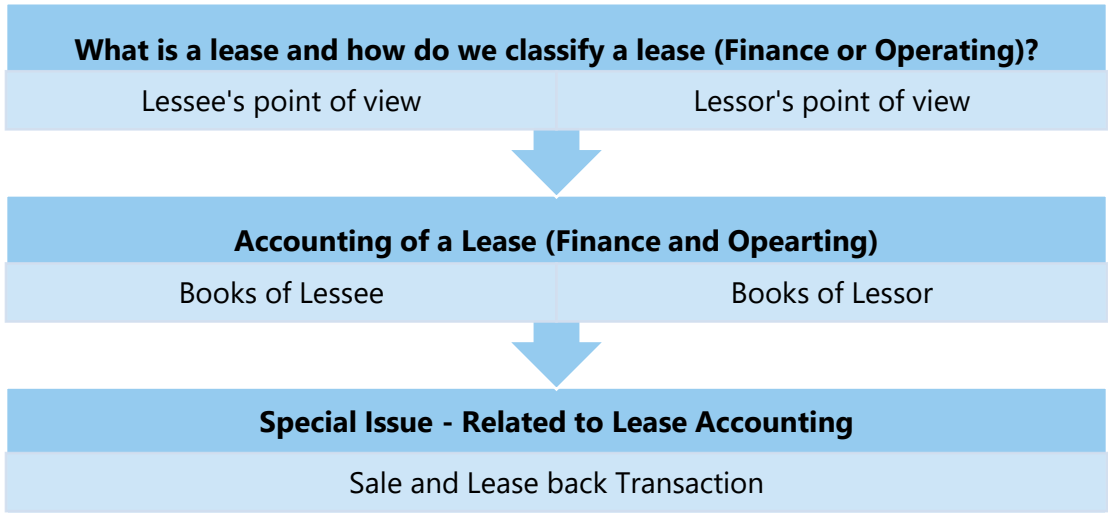
After studying this unit, you will be able to comprehend–

- What is a lease
- What are the parameters for Classification of Leases
- Accounting for leases in the Financial Statements of Lessees
  - Finance Leases
  - Operating Leases
- Accounting for Leases in the Financial Statements of Lessors
  - Finance Leases
  - Operating Leases
- Sale And Leaseback Transactions
- Disclosures required as per the standard.

5.1 INTRODUCTION

Before, we start with the standard, let us lay down the coverage of AS 19 from the examination point of view as under:

Areas covered by AS 19:



The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

What is a Lease?

A *Lease* is an **agreement** whereby the Lessor *(legal owner of an asset)* conveys to the Lessee (another party) in return **for a payment** or series of periodic payments (Lease rents), the **right to use** an asset for an **agreed period of time**.

5.2 APPLICABILITY OF AS 19 [SCOPE]

The standard applies to all leases other than:

(a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

(c) lease agreements to use lands

5.3 DEFINITIONS

A **non-cancellable lease** is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an 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.

The **lease term** is the non-cancellable period for which the lessee has agreed 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.

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.

Minimum lease payments 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

(b) in the case of the lessor, any residual value 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 lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

The above definition can be summarized as under:

Note: The definition can be seen separately from the point of view of Lessee and Lessor.

From the point of view of Lessee	
Case I – Lessee will return the asset at the end of the lease term	**Case II – Lessee will retain the asset at the end of the lease term** (as he has option to buy the asset and it is reasonably certain that he will exercise the option)
Payments over the lease term that the lessee is, or can be required, to make excluding: (a) contingent rent. (b) costs for services and taxes to be paid by and reimbursed to the lessor. + Any residual value guaranteed by or on behalf of the lessee.	Payments over the lease term that the lessee is, or can be required, to make excluding: (a) contingent rent. (b) costs for services and taxes to be paid by and reimbursed to the lessor. + Payment required to exercise the purchase option.

From the point of view of Lessor	
Case I – Lessee will return the asset at the end of the lease term Payments over the lease term that the lessee is, or can be required, to make excluding: (a) contingent rent.	**Case II – Lessee will retain the asset at the end of the lease term** (as he has option to buy the asset and it is reasonably certain that he will exercise the option) **Same as Lessee given above**

(b) costs for services and taxes to be paid by and reimbursed to the lessor. + Any residual value guaranteed: (a) by or on behalf of the lessee; or (b) by an independent third party financially capable of meeting this guarantee.	

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

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.

Note: The economic life is always greater than the useful life of the asset. Useful life represents the depreciable life of an asset whereas, economic life represents the total life during which an asset is capable of generating economic benefits.

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 a 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.

Note: Residual value = Guaranteed Residual value (GRV) + Unguaranteed Residual value (UGRV)

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.

In simple words,

Gross Investment (GI)	**Undiscounted total cash inflows from the point of view of the lessor**
	Undiscounted total of: **(a)** Minimum Lease Payments (MLP); and **(b)** Unguaranteed Residual Value (UGRV). Undiscounted total of: **(a)** Lease Payments; **(b)** Guaranteed residual value (GRV); and **(c)** Unguaranteed Residual value (UGRV). Undiscounted total of: **(a)** Lease Payments; and **(b)** Residual value (GRV and UGRV);

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.

Unearned Finance Income (UFI)	Gross Investment (GI) – Net Investment (NI)
	Gross Investment (GI) – Present value of Gross Investment
	Gross Investment – Fair Value
	Simply speaking = Total Interest

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

In simple words,

Net Investment (NI)	Discounted total cash inflows from the point of view of the lessor
	Discounted total of: **(a)** Minimum Lease Payments (MLP); and **(b)** Unguaranteed Residual Value (UGRV).
	Discounted total of: **(a)** Lease Payments; **(b)** Guaranteed residual value (GRV); and **(c)** Unguaranteed Residual value (UGRV).
	Discounted total of: **(a)** Lease Payments; and **(b)** Residual value (GRV and UGRV);
	Discounted Gross Investment (GI) i.e. Present value of GI
	Simply speaking = Fair value

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; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Interest rate implicit in the lease	**Discount rate at which:** **Cash Outflows = Present value of Cash Inflows** **Where,** **Cash Outflow = Fair value of the asset;** **Cash Inflow = Lease Payments + Residual Value (GRV and UGRV)**
	Simply speaking = Lessor's IRR

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.

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).

The definition of a lease includes agreements 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. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include 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.

5.4 TYPES OF LEASES

For accounting purposes, leases are classified as:

(i) Finance leases; and

(ii) Operating leases.

Finance lease - A lease classified as *Finance Lease* if it transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.

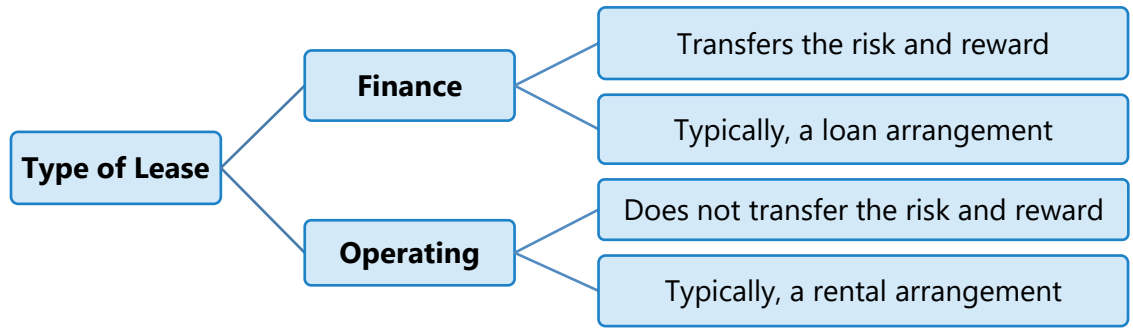
Operating Lease -A lease is classified as an *Operating L*ease if it does not transfer substantially all the risk and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

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 economic life of the asset and of gain from appreciation in value or realisation of residual value.

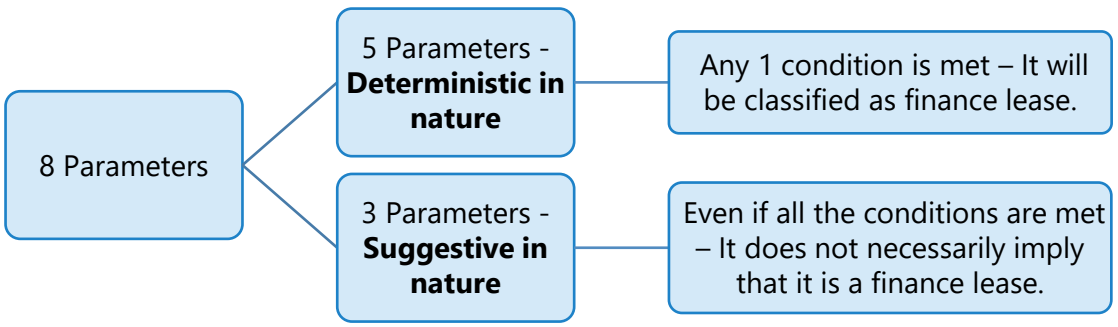
We can summarize the types of lease conceptually as under:



5.5 INDICATORS OF FINANCE LEASE

AS 19 has given a total of 8 parameters to decide whether it is a finance lease or not. (These parameters have been discussed in para 5.6 and 5.7.

These 8 conditions can be divided into following categories:



Let us take up these conditions one by one;

5.6 DETERMINISTIC CONDITIONS

Situations, which would normally lead to a lease being classified as a finance lease are:

(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 such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

Example

Mr. A has taken a car on lease for 5 years from XYZ. After 5 years of lease term Mr. A has the option to purchase this car for ₹ 20,000, whereas it is assumed the car market value at the end of 5th year would be ₹ 2,00,000. Considering the option to buy it at bargain price, it is reasonably certain that Mr. A would exercise that option.

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

Example

XYZ has taken a property on lease for 32 years from ABC, expected economic life of the property is 40 years. Since XYZ is going to use the asset over major part of its economic life (80% in this case), it will meet the condition to be treated as finance lease.

(d) At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) The leased asset is of a specialized nature such that only the lessee can use it without major modifications being made.

Example

PQR, a hospital ordered 10 ambulances, specially designed as per the requirement of PQR. These ambulances are taken on lease and it cannot be used by anyone else without major modifications. This would meet the condition of finance lease.

5.7 SUGGESTIVE CONDITIONS

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

(a) If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee;

(b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and

(c) If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the 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 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as 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.

5.8 ACCOUNTING FOR FINANCE LEASES (BOOKS OF LESSEE)

Following is the accounting treatment of Finance Leases in the books of Lessee:

(i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:

- Fair value of leased asset at the inception of the lease
- Present value of minimum lease payments from the standpoint of the lessee

(Present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used).

Thus, the journal entry at inception will be as under:

Particulars	Debit	Credit
Asset	Refer Note	
To Lessor (Lease Liability)		Refer Note

It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

Note:

The amount will be lower of the two:

(a) Fair value.

(b) Present value of MLP (Minimum Lease payments) from the point of view of lessee.

(ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

(iii) Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

(iv) A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment.

(v) If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

Note:

Cases	Useful life for Depreciation
Case I – Asset will be retained by the lessee	Useful life
Case II – Asset will be returned to the lessor	Useful life or lease term whichever is shorter

(vi) Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The 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.

5.8.1 Computation of interest rate implicit on lease

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; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Discounting rate = R% p.a;

Lease Rents = L_1, L_2 ..... L_n (Payable annually, at the end of each year)

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

$$\text{PV of MLP} = \frac{L_1}{(1+R)^1} + \frac{L_2}{(1+R)^2} + \frac{L_n}{(1+R)^n} + \frac{GR}{(1+R)^n}$$

Present value of unguaranteed residual value = $\frac{UGR}{(1+R)^n}$

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value ..... (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

Example 1

Annual lease rents = *₹ 50,000 at the end of each year.*

Lease period = *5 years;*

Guaranteed residual value = *₹ 25,000*

Unguaranteed residual value (UGR) = *₹ 15,000*

Fair Value at the inception (beginning) of lease = ₹ 2,00,000

Interest rate implicit on lease is computed below:

Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is ₹ 2 lakhs.

PV of minimum lease payments and unguaranteed residual value at guessed rate 10%

Year	MLP + UGR ₹	DF (10%)	PV ₹
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
5	15,000	0.621	9,315
			2,14,340

PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Year	MLP + UGR ₹	DF (14%)	PV ₹
1	50,000	0.877	43,850
2	50,000	0.769	38,450
3	50,000	0.675	33,750
4	50,000	0.592	29,600
5	50,000	0.519	25,950
5	25,000	0.519	12,975
5	15,000	0.519	7,785
			1,92,360

Interest rate implicit on lease is computed below by interpolation:

$$\text{Interest rate implicit on lease} = 10\% + \frac{14\% - 10\%}{2,14,340 - 1,92,360} \times (2,14,340 - 2,00,000) = 12.6\%$$

Example 2

Annual lease rents = ₹ 50,000 *at the end of each year.*

Lease period = 5 *years;*

Guaranteed residual value = ₹ 25,000

Unguaranteed residual value (UGR) = ₹ 15,000

Fair Value at the inception (beginning) of lease = ₹ 2,00,000

Interest rate implicit on lease is =12.6%

Present value of minimum lease payment is computed below:

Year	MLP ₹	DF (12.6%)	PV ₹
1	50,000	0.890	44,500
2	50,000	0.790	39,500
3	50,000	0.700	35,000

4	*50,000*	*0.622*	*31,100*
5	*50,000*	*0.552*	*27,600*
5	*25,000*	*0.552*	*13,800*
			1,91,500

Present value of minimum lease payment = ₹ 1,91,500

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	₹	₹
Asset A/c Dr.	*1,91,500*	
To Lessor (Lease Liability) A/c		*1,91,500*
(Being recognition of finance lease as asset and liability)		

Example 3

Using data for example 2 and assuming zero residual value, allocation of finance charge over lease period is shown below:

Year	***Minimum Lease Payments*** ₹	***Finance Charge (12.6%)*** ₹	***Principal*** ₹	***Principal due*** ₹
0	*--*	*--*	*--*	*1,91,500*
1	*50,000*	*24,129*	*25,871*	*1,65,629*
2	*50,000*	*20,869*	*29,131*	*1,36,498*
3	*50,000*	*17,199*	*32,801*	*1,03,697*
4	*50,000*	*13,066*	*36,934*	*66,763*
5	*75,000*	*8,237**	*66,763*	
	2,75,000	*83,500*	*1,91,500*	

* The difference between this figure and finance charge [66,763×12.6%=8412] is due to approximation in computation.

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

		₹	₹
Finance Charge A/c	*Dr.*	*24,129*	
To Lessor			*24,129*
(Being finance charge due for the year)			
Lessor	*Dr.*	*50,000*	
To Bank A/c			*50,000*
(Being payment of lease rent for the year)			
P & L A/c	*Dr.*	*24,129*	
To Finance Charge A/c			*24,129*
(Being recognition of finance charge as expense for the year)			

Example 4

In example 2, suppose unguaranteed residual value is not determinable and lessee's incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee's incremental borrowing rate.

Present value of minimum lease payment using lessee's incremental borrowing rate 10% is computed below:

Year	***MLP*** ₹	***DF (10%)***	***PV*** ₹
1	*50,000*	*0.909*	*45,450*

2	*50,000*	*0.826*	*41,300*
3	*50,000*	*0.751*	*37,550*
4	*50,000*	*0.683*	*34,150*
5	*50,000*	*0.621*	*31,050*
5	*25,000*	*0.621*	*15,525*
			2,05,025

Present value of minimum lease payment = ₹ 2,05,025

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

		₹	₹
Asset A/c	*Dr.*	*2,00,000*	
To Lessor (Lease Liability)			*2,00,000*
(Being recognition of finance lease as asset and liability)			

Since the liability is recognised at fair value ₹ 2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals ₹ 2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

PV of minimum lease payments at guessed rate 12%.

Year	***Minimum Lease Payments*** ₹	***DF (12%)***	***PV*** ₹
1	*50,000*	*0.893*	*44,650*
2	*50,000*	*0.797*	*39,850*
3	*50,000*	*0.712*	*35,600*
4	*50,000*	*0.636*	*31,800*
5	*50,000*	*0.567*	*28,350*

5	25,000	0.567	14,175
			1,94,425

$$\text{Required discounting rate} = 10\% + \frac{12\% - 10\%}{2,05,025 - 1,94,425} \times (2,05,025 - 2,00,000) = 10.95\%$$

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments ₹	Finance Charge (10.95%) ₹	Principal ₹	Principal due ₹
0	--	--	--	2,00,000
1	50,000	21,900	28,100	1,71,900
2	50,000	18,823	31,177	1,40,723
3	50,000	15,409	34,591	1,06,132
4	50,000	11,621	38,379	67,753
5	75,000	7,247*	67,753	
	2,75,000	75,000	2,00,000	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

		₹	₹
Finance Charge A/c	Dr.	21,900	
To Lessor			21,900
(Being finance charge due for the year)			
Lessor	Dr.	50,000	
To Bank A/c			50,000
(Being payment of lease rent for the year)			

* The difference between this figure & finance charge [67,753×10.95% = 7418] is due to approximation in computation

P & L A/c	*Dr.*	*21,900*	
To Finance Charge			*21,900*
(Being recognition of finance charge as expense for the year)			

Illustration 1

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Lease Payment ₹	Implicit interest rate (Discount rate @15%)	Present value ₹
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	7,50,000*	0.5718	4,28,850
Total	26,25,000		18,55,850

Present value of minimum lease payments ₹ 18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the asset and corresponding lease liability should be recognised at ₹ 18,55,850 as per AS 19.

5.8.2 Disclosures made by the Lessee

The lessee should, in addition to the requirements of AS 10 (Revised), Property, Plant and Equipment, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired 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 periods:

  (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;

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* *Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹ 1,25,000.*

(e) the total of future minimum sublease payments expected to be received under non-cancelable 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.

5.8.3 Accounting for finance leases (Books of lessor)

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.

In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

Journal entries at inception:

Particulars	Debit	Credit
Asset	Fair value	
To Bank		Fair value
(Being purchase of asset by lessor at FV)		
Lease Receivable	Fair value = NI	
To Asset		Fair value = NI
(Being asset by lessor given at lease)		

Where,

Gross investment in Lease (GI)

= Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGRV)

Net investment in Lease (NI)

= Gross investment in Lease (GI) – Unearned Finance Income (UFI).

Unearned finance income (UFI) = GI – (PV of MLP + PV of UGRV)

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

(PV of MLP + PV of UGRV) = Fair Value.

The above definitions imply that:

(a) Unearned Finance Income (UFI) = GI – Fair Value

(b) Net Investment in Lease = GI – UFI = GI – (GI – Fair Value) = Fair Value

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value: Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GI – Cost

= (GI – Fair Value) + (Fair Value – Cost)

= Unearned Finance Income + (Fair Value – Cost)

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. The discounting rate in such situations should be the commercial rate of interest (refer discussion on 'manufacturer or dealer lessor' below).

5.8.4 Recognition of Finance Income

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

5.8.5 Initial Direct Costs

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. 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.

5.8.6 Review of unguaranteed residual value by lessor

AS 19 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly.

In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately.

An upward adjustment of the estimated residual value is not made.

Illustration 2

Prakash Limited leased a machine to Badal Limited on the following terms:

		(₹ In lakhs)
(i)	*Fair value of the machine*	*28.3*
(ii)	*Lease term*	*5 years*
(iii)	*Lease rental per annum*	*8.00*
(iv)	*Guaranteed residual value*	*1.60*
(v)	*Expected residual value*	*3.00*
(vi)	*Internal rate of return*	*15%*

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively.

Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, ***unearned finance income*** is the difference between (a) the ***gross investment*** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

(a) ***Gross investment*** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 8,00,000 × 5 years) + ₹ 1,60,000] + ₹ 1,40,000

= ₹ 43,00,000 (a)

(b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	MLP inclusive of URV (₹)	Internal rate of return (Discount factor @ 15%)	Present Value (₹)
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440
5	8,00,000	0.4972	3,97,760
	1,60,000 (GRV)	0.4972	79,552
	41,60,000		27,61,312 (i)
	1,40,000 (URV)	0.4972	69,608 (ii)
	43,00,000	(i)+ (ii)	28,30,920 (b)

Unearned Finance Income (a) - (b) = ₹ 43,00,000 – ₹ 28,30,920= ₹ 14,69,080.

Manufacturer or dealer lessor

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. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Disclosures

The lessor should 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 the 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 not later than five years;

  (iii) later than five years;

(b) unearned finance income;

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

(d) the accumulated provision for uncollectible 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.

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.

5.9 ACCOUNTING FOR OPERATING LEASES

5.9.1 Accounting treatment in the Books of lessee

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee 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.

Lease payments may be tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, AS 19 requires lessees to recognise operating lease payments as 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.

Example

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1; 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹25,000, ₹45,000 and ₹50,000 respectively.

The total lease payment ₹ 1,20,000 in this example should be recognised in proportion of output as ₹15,000 in year 1, ₹30,000 in year 2 and ₹75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalisation A/c.

The accounting entries for year 1 in books of lessee are suggested below:

		₹	₹
Lease Rent A/c	*Dr.*	*15,000*	

Lease Equalization A/c	*Dr.*	*10,000*	
To Lessor			*25,000*
(Being lease rent for the year due)			
Lessor	*Dr.*	*25,000*	
To Bank A/c			*25,000*
(Being payment of lease rent for the year)			
P & L A/c	*Dr.*	*15,000*	
To Lease Rent A/c			*15,000*
(Being recognition of lease rent as expense for the year)			

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

5.9.2 Disclosures by lessees

The paragraph 25 requires lessees to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases 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;

(b) the total of future minimum sublease payments expected to be received under non-cancelable 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 or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

5.9.3 Accounting treatment in the books of lessor

(i) The lessor should present an asset given under operating lease as PPE in its balance sheet~~s~~.

(ii) Lease income from operating leases should be recognised 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 in which benefit derived from the use of the leased asset is diminished.

(iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.

(iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28

We can summarize the accounting treatment for the lessor and lessee for an operating lease as under:

Particulars	Books of lessor	Books of Lessee
Asset	Continues to appear in his books	Asset does not appear in his books
Depreciation	Yes - charged	Not applicable
Impairment	Yes - applicable	Not applicable
Lease rent	Income recognized on SLM	Expense recognized on SLM

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 rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

A manufacturer or dealer lessor should recognise the asset given on operating lease as PPE in their books by debiting concerned PPE A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales.

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

$$\text{Total lease rent} = 120\% \text{ of } ₹\ 5 \text{ lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}$$

$$= ₹\ 6 \text{ lakhs} \times \frac{60{,}000 \text{ units}}{1{,}25{,}000 \text{ units}} = ₹\ 2.88 \text{ lakhs}$$

Annual lease rent = ₹ 2,88,000 / 3 = ₹ 96,000

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are ₹ 48,000, ₹ 96,000 and ₹ 1,44,000 respectively.

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is ₹ 40,000.

The accounting entries for year 1 in books of lessor are suggested below:

		₹	₹
Machine given on Operating Lease	*Dr.*	*5,00,000*	
To Purchase			*5,00,000*

(Being machine given on operating lease brought into books)			
Lessee	*Dr.*	*96,000*	
To Lease Equalization A/c			*48,000*
To Lease Rent			*48,000*
(Being lease rent for the year due)			
Bank	*Dr.*	*96,000*	
To Lessee			*96,000*
(Being receipt of lease rent for the year)			
Lease Rent	*Dr.*	*48,000*	
To P & L A/c			*48,000*
(Being recognition of lease rent as income for the year)			
Depreciation	*Dr.*	*40,000*	
To Machine given on Operating Lease			*40,000*
(Being depreciation for the year)			
P & L A/c	*Dr.*	*40,000*	
To Depreciation			*40,000*
(Being depreciation for the year transferred to P & L A/c)			

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

5.9.4 Disclosures by lessors

As per AS 19, the lessor should, in addition to the requirements of AS 10 (Revised) 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 recognized in the statement of profit and loss for the period;

(ii) impairment losses recognized 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 ren recognized 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.

5.10 SALE AND LEASEBACK

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

The accounting treatment depends upon the classification of the lease in the books of the seller-lessee.

Situation I

- ***Where sale and leaseback results in finance lease***

The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Situation II

- ***Where sale and leaseback results in operating lease***

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

Profit and loss should be recognised immediately. However 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.

Case 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

For operating leases, if the fair value at the time of a 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 AS 28.

Thus it can be summarised as:

Sale price at fair value	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	No Profit	Recognise profit immediately	Not Applicable
Loss	No Loss	Not Applicable	Recognise loss immediately

Sale price below fair value	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	No Profit	Recognise profit immediately	No Profit. (Carrying amount of an asset to be written down to fair value)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	Carrying amount of an asset to be written down to fair value
Loss compensated by future lease payments at below market price	Defer and amortise loss.	Defer and amortise loss.	Carrying amount of an asset to be written down to fair value

Sale price Above fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	Defer and amortise profit.	1. Difference between carrying amount and fair value to be immediately recognised. 2. Excess over fair value to be Deferred and amortised.	Defer and amortise profit. (The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value)
Loss	No Loss	No Loss	1. Carrying amount of an asset to be written down to fair value. 2. Defer and amortise the difference of sale price and fair value.

Illustration 3

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹ 50 lakhs is equal to fair value.

(b) Fair value is ₹ 60 lakhs.

(c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.

(d) Fair value is ₹ 40 lakhs and sale price is ₹ 50 lakhs.

(e) Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs

(f) Fair value is ₹ 35 lakhs and sale price is ₹ 39 lakhs.

Solution

Following will be the treatment in the given cases:

(a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹ 10 lakhs (i.e. 50 – 40) in its books.

(b) When fair value is ₹ 60 lakhs then also profit of ₹ 10 lakhs should be immediately recognised by A Ltd.

(c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment, otherwise defer and amortise the loss.

(d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortised over the lease period.

(e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognised in its books and balance profit of ₹ 4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs (Fair value ₹ 50 lakhs) and same machinery was leased back by B Ltd. to A Ltd. The lease back is in nature of operating lease. The treatment will be*

   (a) A Ltd. should amortise the profit of ₹ 10 lakhs over lease term.

   (b) A Ltd. should recognise the profit of ₹ 10 lakhs immediately.

   (c) A Ltd. should defer the profit of ₹ 10 lakhs.

   (d) B Ltd. should recognise the profit of ₹ 10 lakhs immediately.

2. *In case of an operating lease – identify which statement is correct:*

   (a) The lessor continues to show the leased asset in its books of accounts.

   (b) The lessor de-recognises the asset from its Balance Sheet.

   (c) The lessor discontinues to claim depreciation in its books.

   (d) The lessee recognises the asset in its Balance Sheet.

3. *In case of finance lease, if the asset is returned back to the lessor at the end of the lease term - the lessee always claims depreciation based on which of the following:*

   (a) Useful life.

   (b) Lease term.

   (c) Useful life or lease term whichever is less.

   (d) Useful life or lease term whichever is higher.

4. *AS 19 lays down 5 deterministic conditions to classify the lease as a finance lease. To classify the lease as an operating lease – which statement is correct?*

   (a) Any 1 condition fails.

   (b) Majority of the 5 conditions fail.

   (c) All 5 conditions fail.

   (d) Any 2 conditions fails.

5. *The basis of classification of a lease is:*

   (a) Control Test.

   (b) Risk and reward Test.

   (c) Both control test and risk and reward test.

   (d) Only reward Test

Theoretical Questions

6. *Explain the types of lease as per AS 19.*

7. *Explain the accounting treatment for a sale and leaseback transaction under Operating lease.*

8. *What do you understand by the term "Interest rate implicit on lease"?*

9. *What are the disclosures requirements for operating leases by the lessee as per AS-19?*

Scenario based Questions

10. *Classify the following into either operating or finance lease:*

    (i) Lessee has option to purchase the asset at lower than fair value, at the end of lease term;

    (ii) Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;

    (iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;

    (iv) Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y".

11. *A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost ₹ 1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. Compute the following:*

    (i) Annual Lease Rent

    (ii) Lease Rent income to be recognized in each operating year and

    (iii) Depreciation for 3 years of lease.

12. *Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000.*

The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However, Lessor Ltd., estimates that the residual value of the machinery will be only ₹ 15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.

13. *B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:*

(i) Lease period is 3 years, in the beginning of the year 2009, for equipment costing ₹ 10,00,000 and has an expected useful life of 5 years.

(ii) The Fair market value is also ₹ 10,00,000

(iii) The property reverts back to the lessor on termination of the lease.

(iv) The unguaranteed residual value is estimated at ₹ 1,00,000 at the end of the year 2011.

(v) 3 equal annual payments are made at the end of each year.

(vi) Consider IRR = 10%.

The present value off ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513. The present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868.

State whether the lease constitute finance lease and also calculate unearned finance income.

14. *X Ltd. sold machinery having WDV of ₹ 300 lakhs to Y Ltd. for ₹ 400 lakhs and the same machinery was leased back by Y Ltd. to X Ltd. The lease back arrangement is operating lease.*

Give your comments in the following situations:

(i) Sale price of ₹ 400 lakhs is equal to fair value.

(ii) Fair value is ₹ 450 lakhs.

(iii) Fair value is ₹ 350 lakhs and the sale price is ₹ 250 lakhs.

(iv) Fair value is ₹ 300 lakhs and sale price is ₹ 400 lakhs.

(v) Fair value is ₹ 250 lakhs and sale price is ₹ 290 lakhs.

ANSWERS/solutions

Answer to the Multiple Choice Questions

1.	(b)	**2.**	(a)	**3.**	(c)	**4.**	(c)	**5.**	(b)

Answer to the Theoretical Questions

6. For the purpose of accounting AS 19, classifies leases into two categories as follows:

1. Finance Lease
2. Operating Lease

Finance Lease:

It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

As per para 8 of the standard, in following situations, the lease transactions are called Finance lease:

1. The lessee will get the ownership of leased asset at the end of the lease term.
2. The lessee has an option to buy the leased asset at the end of the lease term at price, which is lower than its expected fair value at the date on which option will be exercised.

3. The lease term covers the major part of the life of asset even if title is not transferred.

4. At the beginning of lease term, present value of minimum lease rental covers the initial fair value.

5. The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Operating Lease:

It is lease, which does not transfer all the risks and rewards incidental to ownership.

7. As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

Situation 1: Sale price = Fair Value

Profit or loss should be recognized immediately.

Situation 2: Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Situation 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

8. As per para 3 of AS 19 'Leases' 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; and

(b) any unguaranteed residual value accruing to the lessor,

to be equal to the fair value of the leased asset.

9. As per AS 19, lessees are required to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases 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;

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

(c) lease payments recognized 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) recognized 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 or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Answer to the Scenario based Questions

10. (i) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.

(ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

(iii) Since the asset is procured only for the use of lessee, it is a finance lease.

(iv) The lease is a finance lease if X = Y, or where X substantially equals Y.

11. (i) Annual lease rent

Total lease rent

$$= 130\% \text{ of } ₹\ 1,50,000 \times \frac{\text{Output during lease period}}{\text{Total output}}$$

= 130% of ₹ 1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 + 70,000)

= 1,95,000 x 1,50,000 units/3,00,000 units = ₹ 97,500

Annual lease rent = ₹ 97,500 / 3 = ₹ 32,500

(ii) Lease rent Income to be recognized in each operating year

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.

Hence income recognised in years 1, 2 and 3 will be as:

Year 1 ₹ 26,000,

Year 2 ₹ 32,500 and

Year 3 ₹ 39,000.

(iii) Depreciation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40 : 50 : 60 : 80 : 70 .

Depreciation for year 1 is ₹ 20,000, year 2 = 25,000 and year 3 = 30,000**.**

12. As per para 11 of AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Computation of Value of machinery:

Present value of minimum lease payment = ₹ 6,99,054

(See working note below)

Fair value of leased asset = ₹ 7,00,000

Therefore, the recognition will be at the lower of the two i.e. 6,99,054

Working Note - Present value of minimum lease payments:

Annual lease rental × PVIF+ Present value of guaranteed residual value

= ₹ 3,00,000 × (0.869 + 0.756 + 0.657) + ₹ 22,000 × 0.657

= ₹ 6,84,600 + ₹ 14,454 = 6,99,054

Computation of finance charges:

Year	Finance charge	Payment	Reduction in outstanding liability	Outstanding liability
1st Year beginning	–	–	–	6,99,054
End of 1st year	1,04,858	3,00,000	1,95,142	5,03,912
End of 2nd year	75,587	3,00,000	2,24,413	2,79,499
End of 3rd year	41,925	3,00,000	2,58,075	21,424

13. Computation of annual lease payment:

Particulars	₹
Cost of equipment	10,00,000
Unguaranteed residual value	1,00,000
Present value of unguaranteed residual value (₹ 1,00,000 x 0.7513)	75,130
Present value of lease payments (₹ 10,00,000 - ₹ 75,130)	9,24,870
Present value of annuity for three years is 2.4868	
Annual lease payment [9,24,870/2.4868]	3,71,911.70

Classification of lease:

Parameter 1:

The present value of lease payment i.e., ₹ 9,24,870 which equals 92.48% of the fair market value i.e., ₹ 10,00,000.

The present value of minimum lease payments substantially covers the fair value of the leased asset

Parameter 2:

The lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years).

Therefore, it constitutes a finance lease.

Computation of Unearned Finance Income:

Particulars	**₹**
Total lease payments (₹ 3,71,911.70 x 3)	11,15,735
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	1,215,735
Less: Present value of lease payments and residual value i.e.	(10,00,000)
Net Investment (₹ 75,130 + ₹ 9,24,870)	
Unearned finance income	**2,15,735**

14. Accounting Treatment:

S. No.	**Particulars**	**Accounting Treatment**
(i)	When sale price of ₹ 400 lakhs is equal to fair value	X Ltd. should immediately recognize the profit of ₹ 100 lakhs (i.e. 400 – 300) in its books.
(ii)	When fair value is ₹ 450 lakhs	Profit of ₹ 100 lakhs should be immediately recognized by X Ltd.

(iii)	When fair value of leased machinery is ₹ 350 lakhs & sales price is ₹ 250 lakhs	Then loss of ₹ 50 lakhs (300 – 250) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payment.
(iv)	When fair value is ₹ 300 lakhs & sales price is ₹ 400 lakhs	Then, profit of ₹ 100 lakhs is to be deferred and amortized over the lease period.
(v)	When fair value is ₹ 250 lakhs & sales price is ₹ 290 lakhs	Then the loss of ₹ 50 lakhs (300-250) to be immediately recognized by X Ltd. in its books and profit of ₹ 40 lakhs (290-250) should be amortized/ deferred over lease period.