17 AS 19 – LEASES

(I) Types of Lease

A lease transaction is defined as a contract whereby the lessee gets the *right to use* the assets which are owned by the lesser for a specified period for time (Lease term) in consideration for specified consideration (Lease rent).

Lease classification

- Finance lease
  - Substantially all risk and rewards incidental to ownership are transferred to lessee
- Operating Lease
  - In case a Lease is not Finance Lease, it is treated as Operating Lease

The following specific cases are taken as **Finance Lease**

1. If ***ownership automatically*** gets transferred at the end of lease term. Example: Hire purchase

OR

2. If the lessee has an ***option to buy*** the asset at the end of the lease term at a price which is substantially lower than the prevailing fair market value expected

OR

3. If the lease term covers a ***major part*** of the economic life (> 75%)

OR

4. If the present value of minimum lease payments (PV of M.L.P) ***substantially covers*** fair market value at inception (> 90%)

OR

5 If the asset is ***highly specialized*** in nature and can be used by the lessee only and cannot be transferred without making major modifications.

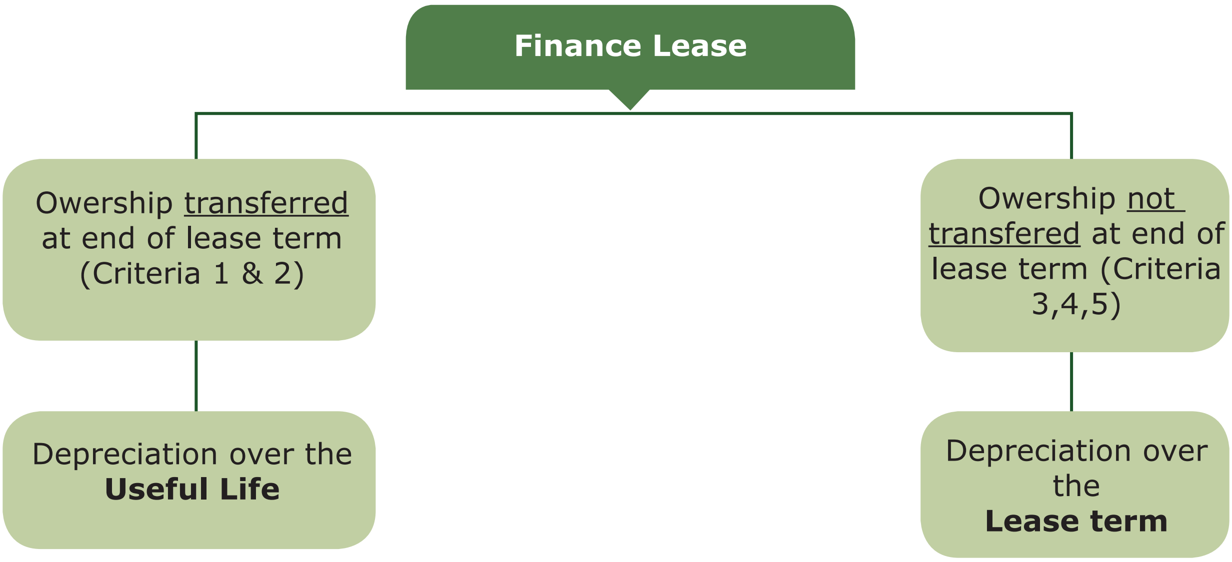
(II) Key Terms

1. **Lease term = Non-Cancellable Period + Renewal Period (in certain cases)**
   Renewal Period should be included only if it is reasonably certain at inception that the renewal will be done.
2. **MLP for lessee = Lease rent (Fixed lease rent) + Guaranteed Residual value (GRV) by lessee + Purchase option (If option at a substantially lower price)**
3. MLP for lessor = Lease rent (Fixed lease rent) + GRV by lessee ***/ independent third party*** + Purchased option (if option is at a substantially lower price)
   The following are **NOT** included in MLP:
   1. Contingent rent.
   2. Refundable deposit.
   3. Expenses of lessee paid by lessor and subsequently reimbursed by lessee.
   4. Unguaranteed residual value (UGRV) UGRV = Expected residual value – GRV (if any)
4. **Guaranteed Residual Value (GRV):**
   It is the fair value of the asset agreed (guarantee to be paid to the lessor) at the end of the lease term. GRV can be for the guarantee given either by the lessee or by an independent third party.
5. **Interest Rate implicit in the lease (Discounting factor):**
   A lease agreement will generally state the lease rental and lease term. However, the rate of interest would not be specified. However, it is implied that the lessor would be charging for the time value from the lessee. This interest rate would be inferred in the following order of preference:
   a. **Lessor Internal Rate of Return (IRR)** i.e the actual rate earned by the lessor.
   b. If the above is not possible, we take the **Lessee's Incremental Borrowings Rate** *i.e. in case the lessee were to borrow, the bankers would charge a specified rate of interest for the financing. It is assumed that in a finance lease, the lessor would also be charging a similar rate.*
6. Initial Direct Cost:
   This refers to the directly attributable cost which are incurred at the time of acquiring the asset under lease. *Example: registration charges in case of property.*

(III) Accounting Treatment (Books of Lessee)

	Finance Lease (Borrowing and Buy)	Operating Lease
Initial Recognition	Asset Dr. xx To Lease Liability xx PV of MLP : xx OR Fair Value : xx *(Whichever is lower)*	No Entry
Annual Entries	Depreciation (P/L) xx To Asset xx *(Note – 1)*	Rent Expense Dr. xx To Bank xx To lease equalisation xx *(Note – 2)*
	Financial Charges Dr. xx (Interest) (P/L) Lease Liabilities *(Balancing figure)* Dr. xx To Bank xx	Profit and loss Dr. xx To Rent xx

Note 1: **<u>Depreciation of an asset in case of Finance lease</u>:**
The asset should be depreciated over the lease term or the useful life depending on the nature of the finance lease.



<u>Note 2</u> : <u>Lease equalisation (Deferred Rent) in case of an Operating Lease</u>:
Lease rentals under an operating lease should be recorded on a **<u>straight line basis</u>** unless any other systematic basis is clearly evident. *(Proportionately higher rent in each year due to more area in each year is an example of systematic basis)*

Example: Lease term 4 Years. Agreed lease rentals are as follows:

Year	Rent
1	10
2	20
3	30
4	40
	100

Lease rent p.a = ₹ 100 / 4 = 25 p.a

In absence of any systematic basis, the journal entries should be:

Date	Particulars		Debit	Credit
Y1	Rent (P/L)	Dr.	25	
	To lease equalisation			15
	To Bank			10
Y2	Rent (P/L)	Dr.	25	
	To Bank			20
	To Lease Equalisation			5
Y3	Rent (P/L)	Dr.	25	
	Lease equalization	Dr.	5	
	To bank			30
Y4	Rent (P/L)	Dr.	25	
	Lease equalization	Dr.	15	
	To bank			40

IV. Accounting in Books of Lessors

	Finance Lease	Operating Lease
Initial Recognition	Lease receivable Dr. xx (Net investment) *(Note – 1)* To Asset xx (Carrying value) To gain (P/L) xx	No Entry
Annual Entries	Bank A/c Dr. xx To Finance Income (P/L) xx To Lease Receivable xx	Bank Dr. xx To Rent Income xx To Lease Equalisation xx *(Similar to note – 2 for lessee)* Rent income Dr. xx To P/L xx Depreciation (P/L) Dr. xx To Asset xx

Note 1

Lessor Specific Terms

1. **Gross investment =** Total MLP (Lessor) + Unguaranteed residual value (UGRV)
2. **Net investment =** PV of gross investment
   = PV of MLP (lessor) + PV of UGRV
3. **Unearned Finance Income =** Gross investment (-) Net investment
   While calculating the present value, the discount factor i.e interest rate implicit in the lease would be taken as the lessor's internal rate of return (IRR). IRR is the rate of return that the Lessor earns on the lease transaction i.e rate at which the present value of cash outflow for the lessor (i.e FV + initial direct cost) equal the presents value of cash inflows for the Lessor (Total MLP + UGRV)

V. Sale and Lease Back

A Sale and lease back transaction results in the assets getting sold and same assets being taken back on lease. The intention of a sale and lease back transaction is to generate immediate cash and at the same time continue with the possession of the asset. It is mainly a financing transaction. The accounting for sale and lease back with respect to *gain/loss on sale* would be as follows: