Lease Accounting

5

Lease is an arrangement by which the lessor gives the right to use an asset for a certain period of time to the lessee on rent. It involves two parties, a lessor and a lessee and an asset which is to be leased. The lessor who owns the asset, agrees to allow to the lessee to use it for a specified period of time in return for periodic rent payments.

The lease transactions derive its accounting complexity from number of alternatives available to the parties involved. Lease can be structured to take tax benefit. It can be used to transfer ownership of the leased asset, and it can also be used to transfer the risk of ownership.

In India, accounting for leases is covered under Accounting Standard (AS) 19 Leases.

Objective

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

Applicability

AS 19 should be applied in accounting for all leases other than:

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

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

(c) lease agreements to use lands.

Important Definitions

The following terms are used in this Standard with the meanings specified:

A **lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

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.

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.

(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.

Unguaranteed Residual value – It is the difference between residual value of asset and its guaranteed residual value is unguaranteed residual value.

Gross Investment is the sum of the following:

(a) Minimum lease payment (from the standpoint of lessor) and

(b) Any unguaranteed residual value accruring to the lessor.

Interest rate implicit in the lease – When the lessor gives an asset on lease (particularly on finance lease), the total amount, which he receives over lease period by giving the asset on lease, includes the element of interest plus payment of principal amount of asset. The rate at which the interest amount is calculated can be simply called implicit rate of interest. More accurately it can be expressed as under

It is the discount rate at which Fair Value of leased Asset (At the inception of lease) is calculated = Present value of [Minimum lease payment (In respect of lessor) + any unguaranteed residual value accruing to the lessor]

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.

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 etc.

Minimum lease payments:

For lessor = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (by or on behalf of lessee) - contingent rent - cost for service and tax to be paid by and reimbursed to lessor + residual value guaranteed by third party.

For lessee = Total lease rent to be paid by lessee over the lease terms any guaranteed residual value (for lessee) - contingent rent - cost for service and tax to be paid by and reimbursed to lessor.

Unearned finance income is the difference between:

(a) the gross investment in the lease; and

(b) the present value of (i) the minimum lease payments under a finance lease from the standpoint of the lessor; and (ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

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

The **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.

Classification of Leases

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

Leases are classified into two types:

1. **Finance lease:** A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred.
2. **Operating lease:** A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

It is important to note that 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 the revised agreement is considered as a new agreement over its revised term. However, 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), do not give rise to a new classification of a lease for accounting purposes.

1. Finance Lease

Finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

Situations which lead to a lease being classified as a finance lease

(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;

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

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

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

Indicators of situations leading to finance lease

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

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

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

Treatment of finance lease in financial statement of lessee

As it is already mentioned that legally the ownership of leased asset remains with lessor but risk and reward of leased asset is transferred to lessee therefore the substance of transactions is lessee becomes the owner, hence the transactions are recorded by substance not by their legal form.

Leased asset as well as liability for lease should be recognised at the lower of-

- Fair value of the leased asset at the inception of lease or

- Present value of minimum lease payment from the lessee point of view, whichever is lower.
- Apportionment of lease payment

Each lease payment is apportioned between finance charge and principal amount. Principal amount is reduced from the outstanding liability. Finance charge is allocated over the lease term in such a manner that it would produce a constant rate of return on the remaining principal balance.

- The lessee in its books should charge depreciation on finance lease asset as per AS-10.
- Initial direct cost for financial lease is included in asset under lease.

Accounting for finance lease - In the books of lessor

The substance of finance lease is that the lessor sells leased assets to lessee

Therefore, the lessor should recognize asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of asset.

Net Investment = Gross Investment - Unearned Finance Income

Gross Investment = (Minimum lease payment from lessor point of view + Unguaranteed residual value).

Unearned Finance Income = Gross Investment - present value of Gross Investment

Recognition of Finance Income

The lessor should recognize the finance income based on a pattern reflecting, constant periodic return on the net investment outstanding in respect of the finance lease. In simple words interest/finance income will be recognized in proportion to outstanding balance receivable from lease over lease period.

Disclosure of financial lease by lessee:

The lessee should, in addition to the requirements of AS 10, Property, Plant & Equipment, 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;

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

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following: (i) the basis on which contingent rent payments are determined; (ii) the existence and terms of renewal or purchase options and escalation clauses; and (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Provided that a Small and Medium Sized Company, as defined in the Notification, may not comply with sub-paragraphs (c), (e) and (f).

Disclosure of financial lease by lessor:

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.

Provided that a Small and Medium Sized Company, as defined in the Notification, may not comply with sub-paragraphs (a) and (f).

2. Operating Lease

Operating lease is a lease other than a finance lease.

Accounting for operating lease

In the books of lessor:

- Record leased out asset as the fixed asset in the balance sheet.
- Charge depreciation as per AS-10.
- Recognize lease income in profit & loss account using straight-line method. If any other method reflects more systematic allocation of earning derived from the diminishing value of leased out asset, that approach can be adopted.
- Other costs of operating lease should be recognized the year in which they are incurred.
- Initial direct cost of the lease may be expensed immediately or deferred.

Accounting for operating lease - In the Books of lessee

Lease payments should be recognized as an expense in the profit and loss account on a straight-line basis over the lease term. If any other method is more representative of the time pattern of the user's benefit, such method can be used.

Disclosure of operating lease:

The lessee should make the following disclosures for operating leases:

(a) the total of future minimum lease payments under noncancellable 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-cancellable subleases at the balance sheet date;

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

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

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following: (i) the basis on which contingent rent payments are determined; (ii) the existence and terms of renewal or purchase options and escalation clauses; and (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Provided that a Small and Medium Sized Company, as defined in the Notification, may not comply with sub-paragraphs (a), (b) and (e).

Sale and Leaseback Transactions

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 lease payments and the sale price are usually interdependent as they are negotiated as a package.

Accounting of sale and leaseback transaction

The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

When a sale and leaseback transaction results in a finance lease: Any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

When a sale and leaseback transaction results in an operating lease: In such a case, if it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

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 the Accounting Standard dealing with impairment of assets.

Illustration 1

Arun Ltd. has taken an equipment on operating lease for the coming 5 years. As per the agreement with the lessor, it will not make any payment for lease rentals for the first 2 years, and will have to pay ₹ 21,00,000 in each of the following 3 years. Advise Arun Ltd. on accounting for the lease rentals in this case.

Solution:

As per AS-19, lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

The pattern of payment, in this case, does not follow straight line basis, rather it is arising towards the end of the lease period. For accounting purpose, such effect should be neutralized i.e. the total payment of ₹ 63,00,000 in the last 3 years should be spread over the entire lease period of 5 years i.e. ₹ 12,60,000 should be charged to the statement of profit and loss for each year.

Illustration 2

Vishnu Ltd. leased a printing machine from Garur Ltd. for a period of 3 years. The useful life of the printing machine is known to be of 5 years. It was agreed between the lessor and lessee that the amount will be paid in 3 instalments and at the termination of the lessee, Garur Ltd. will take back the said machine. The following details are available in respect of the machine lessee:

- Cost of the printing machine is ₹ 15,00,000;
- Unguaranteed residual value at the end of the lease period is ₹ 2,00,000;
- Fair value of the machine is ₹ 15,00,000;
- The internal rate of return of the investment is 10%.

You are required to:

(a) State whether the lease is a finance lease or an operating lease?

(b) Ascertain the amount of unearned finance income.

Given: PVF10%, 3 = 0.7513; PVAF10%, 3 = 2.4868.

Solution:

(a) Present value of unguaranteed residual value = ₹ 2,00,000 × 0.7513 = ₹ 1,50,260

∴ Present value of lease payments = ₹ (15,00,000 – 1,50,260) = ₹ 13,49,740

Present value of lease payments as percentage of Fair value = $\frac{13,49,740}{15,00,000}$ = 90% (approx.)

As the 'Present value of lease payments' makes a substantial portion of the 'Fair value', the machine lease by Vishnu Ltd. from Garur Ltd. is a finance lease by nature.

(b) Annual lease payments = $\frac{\text{Present value of lease payments}}{\text{PVAF10\%, 3}} = \frac{13,49,740}{2.4868}$ = ₹ 5,42,762 (approx.)

Gross investment in lease = ₹ [(₹ 5,42,762 × 3) + 2,00,000] = ₹ 18,28,286

∴ Unearned finance income = Excess of 'Gross investment in lease' over 'Cost of the printing machine'

= ₹ (18,28,286 – 15,00,000)

= ₹ 3,28,286

Illustration 3

PQ Ltd. sold machinery having WDV of ₹80 lakhs to BR Ltd. for ₹ 100 lakhs and the same machinery was leased back by BR Ltd. to PQ Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹100 lakhs is equal to fair value.

(b) Fair value is ₹ 120 lakhs.

(c) Fair value is ₹ 90 lakhs and sale price is ₹ 76 lakhs.

(d) Fair value is ₹ 80 lakhs and sale price is ₹ 100 lakhs.

(e) Fair value is ₹ 92 lakhs and sale price is ₹ 100 lakhs

(f) Fair value is ₹ 70 lakhs and sale price is ₹ 78 lakhs.

Solution:

Following will be the treatment in the given cases:

(a) When sales price of ₹ 100 lakhs is equal to fair value, PQ Ltd. should immediately recognise the profit of ₹ 20 lakhs (i.e. 100 – 80) in its books.

(b) When fair value is ₹ 120 lakhs then also profit of ₹ 20 lakhs should be immediately recognised by PQ Ltd.

(c) When fair value of leased machinery is ₹ 90 lakhs & sales price is ₹ 76 lakhs, then loss of ₹4 lakhs (80 – 76) to be immediately recognised by PQ Ltd. in its books provided loss is not compensated by future lease payment, otherwise it can defer and amortise the loss.

(d) When fair value is ₹80 lakhs & sales price is ₹100 lakhs then, profit of ₹20 lakhs is to be deferred and amortised over the lease period.

(e) When fair value is ₹92 lakhs & sales price is ₹100 lakhs, profit of ₹12 lakhs (92 - 80) to be immediately recognised in its books and balance profit of ₹8 lakhs (100-92) is to be amortised/deferred over lease period.

When fair value is ₹70 lakhs & sales price is ₹78 lakhs, then the loss of ₹10 lakhs (80-70) to be immediately recognised by PQ Ltd. in its books and profit of ₹ 8 lakhs (78-70) should be amortised/deferred over lease period.

Illustration 4

SKS Ltd. has taken the assets on lease from PC Soft Ltd. The following information is given below:

Lease term	=	4 years
Fair value at inception of the lease term	=	₹ 16,00,000
Lease Rent	=	₹ 5,00,000 p.a. at the end of the year
Guaranteed Residual Value	=	₹ 1,00,000
Expected Residual value	=	₹ 3,00,000
Implicit Interest Rate	=	14.97%

Show the accounting in the book of lessee.

Solution:

Present value of minimum lease payment

Year	MLP	Discount rate at 14.97%	PV
1	5,00,000	0.8698	4,34,900
2	5,00,000	0.7565	3,78,250
3	5,00,000	0.6580	3,29,000
4	6,00,000	0.5724	3,43,000
	(Including ₹ 1,00,000)		14,85,590

Present value of minimum lease payment (₹ 14,85,590) which is less than Fair value at the inception of lease (₹ 16,00,000) hende the leased asset and liability will be recognized at ₹ 14,85,590.

Apportionment of Finance Lease: **Rate of Interest 14.97%**

Year	Liability	MLP	Finance Charge	Principal Amt. of reduction
0	14,85,590	-	-	-
1	12,07,983	5,00,000	2,22,393	2,77,607
2	8,88,818	5,00,000	1,80,835	3,19,165
3	5,21,874	5,00,000	1,33,056	3,66,944
4	-	6,00,000	78,125	5,21,875

Books of SKS Ltd.

Lease Rent Account

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
1st year To Bank	5,00,000	By Finance Charge	2,22,393
		By Lease liability A/c	2,77,607
	5,00,000		5,00,000
2nd year To Bank	5,00,000	By Finance Charge	1,80,835
		By Lease liability A/c	3,19,165
	5,00,000		5,00,000
3rd year To Bank	5,00,000	By Finance Charge	1,33,056
		By Lease liability A/c	3,66,944
	5,00,000		5,00,000
4th year To Bank	6,00,000	By Finance Charge	78,126
		By Lease liability A/c	5,21,874
	6,00,000		6,00,000

Lease Liability Account (Lessor)

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
1st year			
To Lease Rental	2,77,607	By Fixed Asset under	14,85,590
To Balance c/d	12,07,983	Finance lease	
	14,85,590		14,85,590
2nd year			
To Lease Rental	3,19,165	By Balance b/d	12,07,903
To Balance C/d	8,88,818		
	12,07,903		12,07,903
3rd year			
To Lease Rent	3,66,944	By Balance b/d	8,88,818
To Balance c/d	5,21,874		
	8,88,818		8,88,818
4th year			
To Lease Rent	5,21,874	By Balance b/d	5,21,874
	5,21,874		5,21,874

Extract of Profit and Loss Account

Year	Particulars	Amount (₹)
1st Year	To Finance Charge	2,22,393
	To Depreciation on leased asset under SLM	3,71,397
2nd Year	To Finance Charge	1,80,835
	To Depreciation	3,71,397
3rd Year	To Finance Charge	1,33,056
	To Depreciation on leased Asset under SLM	3,71,397
4th Year	To Finance Charge	78,125
	To Depreciation on leased Asset under SLM	3,71,397

Extract of Balance Sheet

Liability	Amount (₹)	Asset	Amount (₹)
Lease liability A/c	12,07,983	Fixed Asset under Finance Lease	14,85,590
		Less: Depreciation	3,71,397
			11,14,193
2nd year			
Lease liability A/c	8,88,818	Fixed Asset under Finance Lease	14,85,590
		Less: Depreciation	7,42,794
			7,42,796
3rd year			
Lease liability A/c	5,21,874	Fixed Asset under Finance Lease	14,85,590
		Less: Depreciation	11,14,191
			3,71,399
4th year			
Lease liability A/c	Nil	Fixed Asset under Finance Lease	14,85,590
		Less: Depreciation	14,85,590
			NIL

Illustration 5

RK Soft Ltd. has taken the assets on lease from BD Tech Ltd. The following information is given below:

Lease term	=	4 years
Fair value at inception of lease	=	₹16,00,000
Lease Rent	=	₹5,00,000 p.a. at the end of the year
Guaranteed Residual Value	=	₹1,20,000
Expected Residual value	=	₹3,00,000
Implicit Interest Rate	=	14.97%

Show the accounting in the book of lessor.

Solution:

Lessor should recognize asset given under lease at net investment in lease.

Net investment in lease = Gross investment - unearned finance income

Gross Investment = MLP + Guaranteed residual value + Unguaranteed residual value
= 20,00,000 + 1,20,000 + 1,80,000
= 23,00,000

Unearned finance Income = Gross investment – Present value of gross investment

Present Year	Value of MLP (₹)	Gross investment discount factor	Present Value (₹)
1	5,00,000	0.8698	4,34,900
2	5,00,000	0.7565	3,78,250
3	5,00,000	0.6580	3,29,000
4	8,00,000	0.5724	4,57,920
	23,00,000		16,00,070 say 16,00,000

Unearned finance income = ₹23,00,000 – ₹16,00,000 = ₹7,00,000

Appointment of MLP into Capital recovery & finance income

Year	Balance of lease receivable (₹)	Cash receipts (₹)	Finance (₹)	Capital recovery reduced from receivable (₹)
0	16,00,000	-	-	-
1	13,39,520	5,00,000	2,39,520	2,60,480
2	10,40,045	5,00,000	2,00,525	2,99,475
3	6,95,740	5,00,000	1,55,695	3,44,305
4	-	8,00,000	1,04,260	6,95,747
			7,00,000	16,00,000

The lease receivable account, as shown in the books of lessor will not tally with the lease liability account as shown by the lessee in his book. Difference will remain due to the guaranteed residual value from the third party or /and unguaranteed residual value from the lessee point of view.

Illustration 6

VHR Ltd. availed a lease from Alpha Ltd. on following terms:

- A lease for a tenor of 3 years, in the beginning of year 2021 for equipment costing ₹6,00,000 and which has an expected useful life of 5 years. The fair market value is also ₹6,00,000.
- 3 equal annual payments are made at end of each year.
- The property reverts back to the lessor on termination of the lease.
- The unguaranteed residual value is estimated at ₹75,000 at the end of year 2023.
- IRR = 10%
- The present value of ₹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

(i) State with reason whether the lease constitute finance lease.

(ii) Calculate unearned finance income.

Solution:

(i) Computation of Annual payment to the lessor

PV of residual value (₹)	= 75,000 x 0.7513	=	56,348
PV of lease payments (₹)	= 6,00,000 – 56,348	=	5,43,652
Annual payments (₹)	= 5,43,652 / 2.4868	=	2,18,615

The present value of lease payments i.e. ₹5,43,652 equals 90.60% of the fair market value i.e., ₹6,00,000. As the present value of minimum lease payment substantially covers the initial fair value of the leased assets and leased term (3 years) covers the major part of the life of asset (5 years). Therefore, it constitutes a finance lease.

(ii) Computation of unearned finance income

		Amt. (₹)
Gross investment in the lease	(3 x 2,18,615) + 75,000	7,30,845
Cost of leased property		6,00,000
Unearned finance income		1,30,845

Illustration 7

Beta Ltd. leased a machinery to Gama Ltd. on the following terms:

	(₹ In Lakhs)
Fair value of the machinery	20.00
Lease term	5 years
Lease rental per annuam	5.00
Guaranteed Residual value	1.00
Expected residual value	2.00
Internal Rate of Return	15%

Depreciation is provided on Straight line method @10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Solution:

Present value of MLP (for lessee)

Year	MLP (₹)	Discount Rate	PV (₹)
1	5,00,000	0.8696	4,34,800
2	5,00,000	0.7561	3,78,050
3	5,00,000	0.6575	3,28,750
4	5,00,000	0.5718	2,85,900
5	6,00,000	0.4972	2,98,320
			17,25,820

Note:

It has been assumed that the lease rent is paid at the end of the year

Present value of MLP is less than fair value of ₹20,00,000, so the leased asset and liability should be recognized at ₹17,25,820 in the books of lessee (Beta Ltd.)

Calculation of unearned finance income

Unearned finance income = Gross investment – PV of Gross Investment.

For the Lesser.

Year	MLP (₹)	Discount Rate	P.V. (₹)
1	5,00,000	0.8696	4,34,800
2	5,00,000	0.7561	3,78,050
3	5,00,000	0.6575	3,28,750
4	5,00,000	0.5718	2,85,900
5	7,00,000	0.4972	3,48,040
	27,00,000		17,75,540

Unearned Finance Income –

₹27,00,000 - ₹17,75,540 = ₹9,24,460

Apportionment of MLP into finance charge and principal amount at the end of the year.

Year	Liability (₹)	MLP (₹)	Finance Charge (₹)	Principal (₹)
0	17,25,820	-	-	-
1	14,84,693	5,00,000	2,58,873	2,41,127
2	12,07,397	5,00,000	2,22,704	2,77,296
3	12,07,397	5,00,000	1,81,110	3,18,890
4	8,88,507	5,00,000	1,33,276	3,66,724
5	-	6,00,000	78,267	5,21,733

Entries in the books of Beta Ltd. (lessee) in first year

Particulars		Dr. (₹)	Cr. (₹)
Machinery (leased) A/c	Dr.	17,25,820	
To lease liability			17,25,820
Depreciation A/c	Dr.	1,72,582	
To Machinery A/c			1,72,582
Lease Liability A/c (Beta Ltd.)	Dr.	2,41,127	
Finance Charge	Dr.	2,58,873	
To Bank			5,00,000
Profit & Loss A/c	Dr.	4,31,455	
To Depreciation A/c			1,72,582
To Finance Charges			2,58,873

Exercise

A. Theoretical Questions:

Multiple Choice Questions

1. The person who undertake an agreement, conveys to another person the right to use in return for rent, an assest for an agreed period of time.
   a. Lessor
   b. Lessee
   c. Both
   d. None of the above

2. Operating lease is a _________ .
   a. Revocable contract
   b. Non revocable contract
   c. Operating contract
   d. None of the above

3. Which lease transfer substantially all the risk and rewards incident to ownership of an asset?
   a. Operating lease
   b. Finance lease
   c. Both
   d. None of the above

4. In which types of lease expenses like maintenance, repair, and taxes are born by the lessor?
   a. Operating lease
   b. Financial lease
   c. Both
   d. None of the above

5. Short-term lease which is often cancellable is known as
   a. Finance Lease
   b. Net Lease
   c. Operating Lease
   d. Leverage Lease

6. A lease which is generally not cancellable and covers full economic life of the asset is known as:
   a. Sale and leaseback
   b. Operating Lease
   c. Finance Lease
   d. Economic Lease

7. One difference between Operating and Financial lease is:
   a. There is often an option to buy in operating lease

b. There is often a call option in financial lease.

c. An operating lease is generally cancelable by lease

d. A financial lease in generally cancelable by lease.

Answer:

1	a	2	a	3	b	4	a	5	c	6	c	7	c

Fill in the Blanks

1. As per AS-19 in__________ lease risk and reward is not transferred to the lessee.
2. In financial lease as per As-19 leased assets is shown in the Balanced sheet of _________.
3. __________ account is credited when lessor receive an amount.

Answer:

1	**Operating**	2	**Lessee**
3	**Lessee Account**		

B. Numerical Questions:

Comprehensive Numerical Problems

1. Unique Ltd. availed a lease from Papan Ltd. on following terms:
   - A lease for a tenor of 3 years, in the beginning of year 2020 for equipment costing ₹ 7,00,000 and which has an expected useful life of 5 years. The fair market value is also ₹ 7,00,000.
   - 3 equal annual payments are made at end of each year.
   - The property reverts back to the lessor on termination of the lease.
   - The unguaranteed residual value is estimated at ₹ 75,000 at the end of year 2022.
   - IRR=10%
   - The present value of ₹ 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

   (i) State with reason whether the lease constitute finance lease.

   (ii) Calculate unearned finance income.

[**Answer:** Unearned finance income ₹1,51,451]