AS 19 – Accounting for Lease

Lease is an agreement by which the lessor gives the right to use as assets for given period of time to the lessee on rent.

Type of lease

1. Operating lease
2. Finance Lease

Operating Lease:
It is a lease which does not transfer substantially all the risk and reward incidental to ownership.

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

Applicability: This AS is not applicable to following type of lease:

1. Lease agreement to explore natural resources
2. Lease agreement for motion picture film, video, plays and other rights.
3. Lease agreement to use land.

Accounting for operating lease:

In the books of lessor:

1. Record lease out asset as the fixed assets in the balance sheet.
2. Charge depreciation as per AS 6
3. Recognise lease income in P & L account using straightline method.
4. Other cost of operating lease should be recognized as expenses in the year in which they are incurred.
5. Initial direct cost of lease may be expensed out immediately or deferred as per lease term.

In the books of lessee:

1. Lease payments should be recognized as an expense in the P & L account on a straightline basis over the lease term.

Accounting for finance lease:

In the books of lessor:

1. Recognise asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of assets.

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 – PV of gross investment

2. Recogintion of Finance Income: On the basis of constant periodic return on the net investment outstanding in respect of finance lease.

In the books of Lessee:

1. Lease assets as well as liability for lease should be recognized at the lower of:
   a. Fair value of the leased assets at the in caption of lease, or
   b. PV of minimum lease payment from the lease point of view.
2. Apportionment of lease payment:
   a. Principal Amount: is reduced from the outstanding liability.
   b. Finance charges: is allocated over lease term in such a manner that it would produce a constant rate of return on the remaining principal balance.
3. Charge depreciation on finance lease assets as per AS 6.
4. Initial direct cost for financial lease is included in assets under lease.

Various Terms:

1. Guaranteed residual value:
   a. In respect of lessee: residual value which is guaranteed by or on behalf of lessee.
   b. In respect of lessor: residual value which is guaranteed by or on behalf of lessee or by an independent third party.

2. Unguaranteed residual value: The difference between residual value of assets and its guaranteed residual value is unguaranteed residual value.

3. Minimum Lease payment:

   a. For Lessor:

      Total lease rent to be paid by lessee over the lease terms
      +Any guaranteed residual value
      - Contingent rent
      - Cost for service and tax to be paid
      +Residual value guaranteed by the third party

   b. For Lessee:

      Total lease rent to be paid by lessee over the lease terms
      +Any guaranteed residual value
      - Contingent rent
      - Cost for service and tax to be paid by and reimbursed to lessor

4. Contingent Rent: Lease rent fixed on the basis of percentage of sales, amount of uses, price indices, market rate of interest is called contingent rent.
5. PV of leased assets: PV of minimum lease payment + unguaranteed residual value

Eg: Finance Lease accounting in the books of lessee:

Fair value of Machinery	Rs. 20 Lacs
Lease term	5 Years
Lease rental per annum	Rs. 5 Lacs
Rate of interest	10%
Rate of Depreciation	5%

Solution:

Calculation of PV of minimum lease payment

Year	Minimum Lease Payment	Discount Factor	Present Value
1	500000	0.909	454,545
2	500000	0.826	413,223
3	500000	0.751	375,657
4	500000	0.683	341,507
5	500000	0.621	310,461
			1,895,393

It is assumed that rent is paid at the end of period.

PV of minimum lease payment is less than fair value of Rs. 20 Lacs, so the leased asset and liability should be recognized at Rs. 18,95,393/- in the books of lessee.

Year	Liability (A)	Minimum lease payment (B)	Finance Charges (C=A*10%)	Principal (D=B-C)
0	1,895,393			
1	1,584,933	500,000	189,539	310,461
2	1,243,426	500,000	158,493	341,507
3	867,769	500,000	124,343	375,657
4	454,545	500,000	86,777	413,223
5	-	500,000	45,455	454,545

Entries in the books of lessee:

Machinery A/c	Dr.	18,65,393
To Lease Liability		18,65,393
Depreciation A/c	Dr.	94,769
To Machinery		94,769
Lease liability A/c	Dr.	3,10,461
Finance charges A/c	Dr.	1,89,539
To Bank		5,00,000
P & L A/c	Dr.	2,84,308
To Depreciation		94,769
To Finance Charges		189,539