After studying this unit, you will be able to understand:

- the objective and scope of this standard
- the terms like lease, finance lease, operating lease, minimum lease payments etc.
- criteria for classification of lease - finance and operating lease
- accounting and disclosure for finance lease in the books of lessor and lessee
- accounting and disclosure for operating lease in the books of lessor and lessee
- sale and leaseback transaction where leaseback is either: finance lease or operating lease
Objective
to prescribe appropriate accounting policies and disclosure to apply in relation to leases

- sale and leaseback transaction where leaseback is either: finance lease or operating lease
- criteria for classification of lease - finance and operating lease
- accounting and disclosure for operating lease in the books of lessor and lessee
- accounting and disclosure for finance lease in the books of lessor and lessee
3.1 OBJECTIVE

The objective of this Standard is to prescribe for lessees and lessors:

(i) the appropriate accounting policies to be used and

(ii) disclosures applicable to leases

Leases are required to be classified as either finance leases (which transfers substantially all the risks and rewards incidental to ownership, and give rise to asset and liability recognition by the lessee and a receivable by the lessor) or operating leases (which does not transfers substantially all the risks and rewards incidental to ownership and result in expense recognition by the lessee with the asset remaining recognised by the lessor).

3.2 SCOPE

This Standard applies in accounting for all leases other than:

(a) lease agreements to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

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

This Standard shall not be applied as the basis of measurement for:

(a) property held by lessees that is accounted for as investment property (Ind AS 40, Investment Property);

(b) investment property provided by lessors under operating leases (to be accounted as per Ind AS 40, Investment Property);

(c) biological assets within the scope of Ind AS 41 Agriculture held by lessees under finance leases; or

(d) biological assets within the scope of Ind AS 41 provided by lessor under operating leases.

This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, motor vehicles and photocopiers. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.
3.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **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.

Lessor is a party who gives the asset on lease and gets lease rent whereas Lessee is one who takes the asset on lease and pays rent periodically or as per agreed terms.

**Illustration 1**

*Moon & Sun legal consultants Limited has signed an agreement with a client for rendering consultancy services on monthly basis for 15 days per month for 2 years at a fees of Rs 1 million per annum. Is this agreement tantamount to a lease?*

**Solution**

For an agreement considered to be lease, below four conditions should be there:

(i) Agreement between two parties should be there

(ii) Consideration in Payment or series of payments
(iii) Agreed period of time
(iv) Right to use of an asset

In this case all of the conditions except right to use an asset is fulfilled. This agreement is for the use of services. Hence it is not covered within the purview of Ind AS 17.

- **A finance lease** is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

- **An operating lease** is a lease other than a finance lease.

- **A non-cancellable lease** is a lease that is cancellable only:
  (a) upon the occurrence of some remote contingency;
  (b) with the permission of the lessor;
  (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
  (d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

- The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:
  (a) a lease is classified as either an operating or a finance lease; and
  (b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.
The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e., the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

**Example: Inception of the Lease and Commencement of the lease**

A lessee may sign an agreement to lease a car on 31 March 20X1 but does not take delivery of the car until 30 June 20X1. Lease classification is made at the inception of the lease i.e. on 31 March 20X1. The recognition of the related assets, liabilities, income and expense in the financial statements will not take place until 30 June 20X1. Commencement of the lease will be on 30 June 20X1.

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

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) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

(b) for a lessor, any residual value guaranteed to the lessor by:
   (i) the lessee;
   (ii) a party related to the lessee; or
   (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

**Illustration 2**

Calculate minimum lease payments for A Ltd. who took an asset on a 5 years lease from B Ltd. using the following information:

<table>
<thead>
<tr>
<th>Payments over the lease term</th>
<th>₹ 1,000 per month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent rent</td>
<td>₹ 20,000</td>
</tr>
<tr>
<td>Cost for services given by B Ltd.</td>
<td>₹ 40,000</td>
</tr>
<tr>
<td>Taxes to be reimbursed to B Ltd.</td>
<td>₹ 15,000</td>
</tr>
<tr>
<td>Residual value guaranteed by A Ltd.</td>
<td>₹ 5,000</td>
</tr>
<tr>
<td>Fair value of asset after 5 years</td>
<td>₹ 6,000</td>
</tr>
</tbody>
</table>

Also, A Ltd. has an option to purchase the asset after a period of 5 years at ₹ 2,000. It is reasonably certain that A Ltd. will exercise the option.

**Required**

Calculation Minimum Lease Payments.
Solution

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments over the lease term (1,000 x 12 x 5)</td>
<td>60,000</td>
</tr>
<tr>
<td>Contingent rent</td>
<td>-</td>
</tr>
<tr>
<td>Cost for services given by B Ltd.</td>
<td>-</td>
</tr>
<tr>
<td>Taxes to be reimbursed to B Ltd.</td>
<td>-</td>
</tr>
<tr>
<td>Residual value guaranteed by A Ltd.</td>
<td>5,000</td>
</tr>
<tr>
<td>Payment made for option to purchase the asset</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Minimum lease payments for A Ltd.</strong></td>
<td><strong>67,000</strong></td>
</tr>
</tbody>
</table>

- **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.

  Ind AS 17 uses the term ‘fair value’ in a way that differs in some respects from the definition of fair value in Ind AS 113, *Fair Value Measurement*. Therefore, when applying Ind AS 17 an entity measures fair value in accordance with Ind AS 17, not Ind AS 113.

- **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** is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

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- **Guaranteed residual value** is:
  (a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
  (b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

- **Unguaranteed residual value** is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

- **Initial direct costs** are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

- **Gross investment in the lease** is the aggregate of:
  (a) the minimum lease payments receivable by the lessor under a finance lease, and
  (b) any unguaranteed residual value accruing to the lessor.

- **Net investment in the lease** is the gross investment in the lease discounted at the interest rate implicit in the lease.

- **Unearned finance income** is the difference between:
  (a) the gross investment in the lease, and
  (b) the net investment in the lease.

**Illustration 1**

X Ltd. gave an asset on a finance lease to Y Ltd. Y Ltd. has to pay ₹10,000 per annum for 5 years. Unguaranteed residual value accruing to X Ltd. is ₹5,000. Interest rate implicit in the lease is 15%. Calculate gross investment, net investment and unearned finance income.
**Example: Calculation of interest rate implicit in the lease**

<table>
<thead>
<tr>
<th>Fair value of asset</th>
<th>₹ 90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial direct costs to the lessor</td>
<td>₹ 10,000</td>
</tr>
<tr>
<td>Annual lease payments (at year end)</td>
<td>₹ 25,000 for 6 years</td>
</tr>
<tr>
<td>Unguaranteed residual value at the end of 6 years</td>
<td>₹ 5,000</td>
</tr>
</tbody>
</table>

Interest rate implicit in the lease can be calculated using spread sheet in the following manner:

<table>
<thead>
<tr>
<th>A</th>
<th>1</th>
<th>-1,00,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>30,000</td>
<td></td>
</tr>
</tbody>
</table>

8 \( = \text{IRR (A1: A7)} \) \( \text{IRR} = 13.82\% \)

i.e., interest rate implicit in the lease = 13.82%
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 the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).

Illustration 2: Contingent Rent

A car is leased under a three year contract. The lease rentals during the three years are fixed provided the mileage does not exceed a maximum amount during that period. Any mileage incurred above the maximum is subject to an additional charge.

How should the minimum lease rentals be calculated?

Solution

The minimum lease payments (MLP) should include only the fixed rent. The charges for excess mileage are contingent and should not be included in the minimum lease payments.

Such contingent rent should be charged to profit and loss, when incurred.

3.4 CLASSIFICATION OF LEASE

3.4.1 Criteria for Classification of Lease

- A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

- The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental 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 because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset’s economic life and of gain from appreciation in value or realisation of a residual value.
3.4.2 Lease classification is made at the inception of the lease

- 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, which would have resulted in a different classification of the lease had the revised terms been in effect at the inception of the lease, shall be considered as the inception of a revised agreement over the remaining term.

- However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

**Illustration 3: Lease renegotiation results in reclassification of operating lease as a finance lease**

*Entity A leases a building. The original term of the lease was for 30 years and the estimated useful and economic life of the building at the start of the lease was 45 years. At inception the lease was classified as an operating lease. Now, nearing the end of the 30 years, the lease has been renegotiated. The new lease term is 20 years, which is equal to the revised expected remaining economic life of the building.*

*Should the classification of the lease be re-assessed?*
Solution

The provisions of the lease have changed significantly. The lease is now for a major part of the economic life of the asset. Leases of this type would normally be classed as a finance lease. Therefore, the classification of the lease should be reassessed.

This contrasts with the treatment of a change in estimate where the lease classification would not be revisited.

For example, if it had emerged during the first lease that the economic life of the building was not 45 years, but only 35 years, the original classification as an operating lease should still be kept until the end of the lease term.

### 3.4.3 Characteristics of a finance lease

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

#### 3.4.3.1 Primary indicators of a finance lease are:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.
- 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.
- The leased assets are of such a specialised nature that only the lessee can use them without major modifications.
3.4.3.2 Additional indicators of a finance lease include:

Other indicators that, individually or in combination could also lead to a lease being classified as a finance lease are:

- if the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee
- gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

The indicators set out above are intended to identify the key characteristics of a finance lease but they are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Illustration 4 : Lease Classification

On 1 April 20X1, Sun Ltd entered, as lessee, into a five-year non-cancellable lease of an equipment that has an economic life of ten years, at the end of which it is expected to have no value. At the inception of the lease, the fair value (cash cost) of the Equipment is ₹ 1,00,000. On 31 March for each of the first four years of the lease term the lessee is required to pay the lessor ₹ 23,000. At the end of the lease term ownership of the Equipment passes to the lessee upon payment of the final lease payment of ₹ 23,539. The interest rate implicit in the lease is 5 per cent per year, which approximates the lessee’s incremental borrowing rate.

Solution

The arrangement is a finance lease. At the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance the lessee owns the asset from the inception of the lease.

The finance lease classification is substantiated by following events:

- the lease transfers ownership of the asset to the lessee by the end of the lease term; and
- at the inception of the lease the present value of the minimum lease payments amounts to all of the fair value of the leased asset. The calculation of present value of the minimum lease payments as ₹ 1,00,000, i.e., substantially all of the fair value of the leased asset.

### Computation of Present value of Minimum lease payments

<table>
<thead>
<tr>
<th>Year</th>
<th>Discount Factor (A)</th>
<th>Minimum Lease payments (MLP) (B)</th>
<th>Present value of Lease payments (A x B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 March 20X2</td>
<td>0.952</td>
<td>23,000</td>
<td>21,896</td>
</tr>
<tr>
<td>31 March 20X3</td>
<td>0.907</td>
<td>23,000</td>
<td>20,861</td>
</tr>
<tr>
<td>31 March 20X4</td>
<td>0.864</td>
<td>23,000</td>
<td>19,872</td>
</tr>
<tr>
<td>31 March 20X5</td>
<td>0.823</td>
<td>23,000</td>
<td>18,929</td>
</tr>
<tr>
<td>31 March 20X6</td>
<td>0.784</td>
<td>23,539</td>
<td>18,442</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>1,00,000</strong></td>
</tr>
</tbody>
</table>

### 3.4.4 Leases of land and buildings

- When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with the general criteria discussed above. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

- Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.

- If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

- For a lease of land and buildings under which the present value of the minimum lease payments allocated to the land at the inception of the lease is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with the general criteria discussed above. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.
Illustration 5

On 1 April 2017, Jupiter Ltd began to lease a property on a 20-year lease. Jupiter Ltd paid a lease premium of ₹30,00,000 on 1 April 2017. The terms of the lease required Jupiter Ltd to make annual payments of ₹500,000 in arrears, the first of which was made on 31 March 2018.

On 1 April 2017 the fair values of the leasehold interests in the leased property were as follows:

- **Land** ₹30,00,000.
- **Buildings** ₹45,00,000.

There is no opportunity to extend the lease term beyond 31 March 2037. On 1 April 2017, the estimated useful economic life of the buildings was 20 years.

The annual rate of interest implicit in finance leases can be taken to be 9·2%. The present value of 20 payments of ₹1 in arrears at a discount rate of 9·2% is ₹9.

Required:

Explain the accounting treatment for the above property lease and produce appropriate extracts from the financial statements of Jupiter Ltd for the year ended 31 March 2018.

**Solution**

**Statement of Profit and Loss**

<table>
<thead>
<tr>
<th>Description</th>
<th>₹ ’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating lease rental</td>
<td>(260)</td>
</tr>
<tr>
<td>Amortisation of asset leased on finance lease</td>
<td>(225)</td>
</tr>
<tr>
<td>Finance cost relating to finance leases</td>
<td>(248·4)</td>
</tr>
</tbody>
</table>

**Balance Sheet**

<table>
<thead>
<tr>
<th>Description</th>
<th>₹ ’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>4,275</td>
</tr>
<tr>
<td>Prepaid operating lease rentals:</td>
<td></td>
</tr>
<tr>
<td>In non-current assets</td>
<td>1,080</td>
</tr>
<tr>
<td>In current assets</td>
<td>60</td>
</tr>
</tbody>
</table>

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Lease liability:

<table>
<thead>
<tr>
<th></th>
<th>In non-current liabilities</th>
<th>In current liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(2,592·1)</td>
<td>(56·3)</td>
</tr>
</tbody>
</table>

Explanation and supporting calculations:

Separate decisions are made for the land and buildings elements of the lease.

1) **The land lease is an operating lease** because land has an indefinite useful economic life and the lease term is 20 years.

   The lease premium and annual rentals are apportioned 40% (3/7·5) to the land element.

   Therefore the premium for the land element is ₹ 12,00,000 (₹ 30,00,000 X 40%) and the annual rentals for the land element ₹ 200,000 (₹ 500,000 X 40%). This makes the total lease payments ₹ 52,00,000 (₹ 12,00,000 + 20 X ₹ 200,000).

   The rental expense for the current period is ₹ 2,60,000 (₹ 52,00,000 X 1/20).

   The amount paid in the current period re: the land element is ₹ 14,00,000 (₹ 12,00,000 + ₹ 200,000). Therefore there is a prepayment of ₹ 1,140,000 (₹ 14,00,000 – ₹ 2,60,000) at the year end.

   In the next 19 periods, the rental expense will be ₹ 260,000 and the rental payment will be ₹ 200,000. Therefore ₹ 60,000 of the rental prepayment will reverse in each period. This means that ₹ 60,000 of the prepayment will be a current asset, and the balance a non-current asset.

2) **The buildings element of the lease will be a finance lease** because the lease term is for substantially all of the useful life of the buildings.

   The premium apportioned to the buildings element is ₹ 18,00,000 (₹ 30,00,000 X 60%) and the annual rental apportioned to the buildings is ₹ 300,000 (₹ 500,000 X 60%).

   The initial carrying value of the leased asset in PPE is ₹ 45,00,000 (₹ 18,00,000 + ₹ 300,000 X 9).

   Therefore the annual depreciation charge is ₹ 2,25,000 (₹ 45,00,000 X 1/20) and the closing PPE (₹ 45,00,000 – ₹ 2,25,000).

   The finance cost in respect of the finance lease and the closing non-current liability is shown in the working below.

   The closing current liability is ₹ 56,300 (₹ 26,48,400 – ₹ 25,92,100).
Lease liability profile – working

<table>
<thead>
<tr>
<th>Year ended 31 March</th>
<th>Bal b/f ₹’000</th>
<th>Finance Cost @9.2% ₹ ’000</th>
<th>Lease rental payment ₹ ’000</th>
<th>Bal c/f ₹ ’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>*2,700</td>
<td>248·4</td>
<td>(300)</td>
<td>2,648·4</td>
</tr>
<tr>
<td>2019</td>
<td>2,648·4</td>
<td>243·7</td>
<td>(300)</td>
<td>2,592·1</td>
</tr>
</tbody>
</table>

* = Net of lease premium of ₹ 18,00,000 (₹ 45,00,000 – ₹ 18,00,000 = ₹ 27,00,000).

3.5 LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

3.5.1 Accounting and Disclosure by Lessees in case of Finance Leases

3.5.1.1 Initial Recognition

- At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.

In Balance Sheet Recognise:
- leased asset as an asset and
- obligation to pay future rentals as a liability.

Amount to recognize: Lower of
- fair value of the leased asset
- the present value of the MLP.

- It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets. If for the presentation of liabilities in the balance sheet a distinction is made between current and noncurrent liabilities, the same distinction is made for lease liabilities.

- Any initial direct costs of the lessee are added to the amount recognised as an asset. Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognised as an asset.
The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee’s incremental borrowing rate shall be used.

3.5.1.2 Subsequent Measurement

Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents are recognised as expenses in the periods in which they are incurred.

A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with Ind AS 16, Property, Plant and Equipment and Ind AS 38, Intangible Assets.

A lessee is also required to recognise any impairment of a leased asset. To determine whether a leased asset has become impaired, an entity applies Ind AS 36, Impairment of Assets.

3.5.1.3 Disclosure Requirements for Lessees in case of Finance Leases

Finance leases fall within the definition of financial instruments as set out in Ind AS 32 Financial Instruments: Presentation. Therefore lessees, in addition to meeting the requirements of Ind AS 107, Financial Instruments: Disclosures, make the following disclosures for finance leases:

(a) for each class of asset, the net carrying amount at the end of the reporting period;
(b) a reconciliation between the total of future minimum lease payments at the end of the reporting period, and their present value;
(c) the total of future minimum lease payments at the end of the reporting period, 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; and
   (iii) later than five years.
(d) contingent rents recognised as an expense in the period;
(e) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the end of the reporting period; and
(f) a general description of the lessee’s material leasing arrangements including, but not limited to, the following:
(i) the basis on which contingent rent payable is 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.

- In addition, the requirements for disclosure in accordance with Ind AS 16, Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41 apply equally to assets held under finance leases.

### Illustration 6

On 1 April 20X1, Venus ltd began to lease a property that was used in the production process. The lease was for 4 years and annual rental (payable in advance on 1st April each year) was ₹20,00,000.

The rate of interest implicit in this lease was 9% p.a. and the present value of the minimum lease payments was very close to the fair value of the property at the inception of the lease, which was estimated at ₹71,00,000.

Required:

Explain the accounting treatment for the above property lease and produce appropriate extracts from the financial statements of Venus ltd for the year ended 31 March 20X2.

### Solution

- The lease is a finance lease.

- Initial recognition:-

<table>
<thead>
<tr>
<th>Leased Asset A/c</th>
<th>Dr.</th>
<th>71,00,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>To liability (P.V. of MLP)</td>
<td></td>
<td>71,00,000</td>
</tr>
</tbody>
</table>

- The effective finance cost of the liability is 9% p.a.:

<table>
<thead>
<tr>
<th>Opening balance</th>
<th>Lease rental payment</th>
<th>Balance in period</th>
<th>Finance Cost</th>
<th>Closing Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>₹71,000</td>
<td>₹20,000</td>
<td>₹51,000</td>
<td>₹4,590</td>
<td>₹55,590</td>
</tr>
</tbody>
</table>

© The Institute of Chartered Accountants of India
Balance Sheet on 31st March 20X2

<table>
<thead>
<tr>
<th>Liability</th>
<th>₹ '000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liability</td>
<td>20,000</td>
</tr>
<tr>
<td>Non-Current Liability</td>
<td>35,590</td>
</tr>
<tr>
<td></td>
<td>55,590</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asset</th>
<th>₹ '000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leased Asset</td>
<td>71,000</td>
</tr>
<tr>
<td>Less: Depreciation (71,000/4)</td>
<td>(17,750)</td>
</tr>
<tr>
<td></td>
<td>53,250</td>
</tr>
</tbody>
</table>

Statement of Profit and Loss for the year ended 31st March 20X2

<table>
<thead>
<tr>
<th></th>
<th>₹ '000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation over 4 years</td>
<td>71,000/4</td>
</tr>
<tr>
<td>Finance Cost</td>
<td></td>
</tr>
</tbody>
</table>

3.5.2 Accounting and Disclosure by Lessees in case of Operating Leases

3.5.2.1 Operating Lease Payments to be recognised on a Straight-Line Basis

- Lease payments (excluding costs for services such as insurance and maintenance) under an operating lease shall be recognised as an expense on a straight-line basis, even if the payments are not on that basis, over the lease term unless either:
  (a) another systematic basis is more representative of the time pattern of the user’s benefit even if the payments to the lessors are not on that basis; or
  (b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor’s expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition is not met.

3.5.2.2 Disclosure Requirements for Lessees in case of Operating Leases

- Lessees are required to make the following disclosures for operating leases:
  (a) the total of future minimum lease payments under non-cancellable 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; and
    (iii) later than five years.
(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the end of the reporting period;

(c) lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

(d) a general description of the lessee’s significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is 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.

3.6 LEASES IN THE FINANCIAL STATEMENTS OF LESSORS

3.6.1 Accounting and Disclosure by Lessors in case of Finance Leases

3.6.1.1 Initial Recognition

- Lessors are required to recognise assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease.

- Under a finance lease substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.

- For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the lease term.

- Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team.

- The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable.
3.6.1.2 Subsequent Measurement

- The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor’s net investment in the finance lease. Lease payments relating to the period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

- Estimated unguaranteed residual values used in computing the lessor’s gross investment in the lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately.

- An asset under a finance lease that is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, shall be accounted for in accordance with that Ind AS.

3.6.1.3 Accounting by Manufacturer and Dealer Lessor

- Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

  (a) profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

  (b) finance income over the lease term.

- Manufacturer or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.

- The sales revenue recognised at the commencement of the lease term by a manufacturer or dealer lessor is the fair value of the asset, or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest.

- Thus, if artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.

- Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised.

- Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease and are recognised as an expense when the selling profit is recognised, which for a finance lease is normally at the commencement of the lease term.
3.6.1.4 Disclosure Requirements for Lessors in case of Finance Leases

- Finance leases fall within the definition of financial instruments as set out in Ind AS 32 *Financial Instruments: Presentation*. Therefore lessors, in addition to meeting the requirements of Ind AS 107, *Financial Instruments: Disclosures*, make the following disclosures for finance leases:

  (a) a reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period;

  (b) the gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for each of the following periods:
      (i) not later than one year;
      (ii) later than one year and not later than five years; and
      (iii) later than five years.

  (c) unearned finance income;
  (d) the unguaranteed residual values accruing to the benefit of the lessor;
  (e) the accumulated allowance for uncollectible minimum lease payments receivable;
  (f) contingent rents recognised as income in the period; and
  (g) a general description of the lessor’s material leasing arrangements.

- As an indicator of growth it is often useful also to disclose the gross investment less unearned income in new business added during the period, after deducting the relevant amounts for cancelled leases.

3.6.2 Accounting and Disclosure by Lessors in case of Operating Leases

3.6.2.1 Presentation of Assets subject to Operating Leases

Lessors are required to present assets subject to operating leases in their balance sheet according to the nature of the asset.

3.6.2.2 Rental Income

- Lease income from operating leases (excluding amounts for services such as insurance and maintenance) shall be recognised in income on a straight-line basis (even if the receipts are not on such a basis) over the lease term, unless either:

  (a) another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished, even if the payments to the lessors are not on that basis; or
(b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then this condition is not met.

Illustration 7

On 1 April 20X1, Mercury Ltd leased a machine from Pluto Ltd on a three-year lease. The expected future economic life of the machine on 1 April 20X1 was eight years. If the machine breaks down, then under the terms of the lease, Pluto Ltd would be required to repair the machine or provide a replacement. Pluto Ltd agreed to allow Mercury Ltd to use the machine for the first six months of the lease without the payment of any rental as an incentive to Mercury Ltd to sign the lease agreement. After this initial period, lease rentals of ₹2,10,000 were payable six-monthly in arrears, the first payment falling due on 31 March 20X2.

Required:
Explain the treatment required in accordance of Ind AS 17 in the financial statements of Mercury Ltd for the year ended 31 March 20X2.

Solution

Under the principles of Ind AS 17 – Leases – the lease of the machine is an operating lease because the risks and rewards of ownership of the machine remain with Pluto Ltd. The lease is for only three years of the eight-year life and Pluto Ltd is responsible for breakdowns, etc.

Therefore Mercury Ltd will recognise lease rentals as an expense in the statement of profit or loss. Ind AS 17 states that this shall normally be done on a straight-line basis.

The total lease rentals payable over the whole lease term are ₹1,050,000 (₹210,000 x 5). Therefore the charge for the current year is ₹350,000 (₹1,050,000 x 1/3).

The difference between the charge for the period (₹350,000) and the rent actually paid (₹210,000) will be shown as a liability in the statement of financial position at 31 March 20X2.

This amount will be ₹140,000. ₹70,000 (2 x ₹210,000 – ₹350,000) of this liability will be current and ₹70,000 non-current.

3.6.2.3 Other key points

- Costs, including depreciation, incurred in earning the lease income are recognised as an expense.
- Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.
The depreciation policy for depreciable leased assets shall be consistent with the lessor’s normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with Ind AS 16 and Ind AS 38.

To determine whether a leased asset has become impaired, an entity applies Ind AS 36.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

3.6.2.4 Disclosure Requirements for Lessors in case of Operating Leases

Lessors shall, in addition to meeting the requirements of Ind AS 107, disclose the following for operating leases:

(a) 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; and
   (iii) later than five years.

(b) total contingent rents recognised as income in the period; and

(c) a general description of the lessor’s leasing arrangements.

In addition, the disclosure requirements in Ind AS 16, Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41 apply to lessors for assets provided under operating leases.

Illustration 8: Operating and Finance Lease

On 1 April 20X1 Venus Ltd entered into two leasing contracts:

The first contract was a contract to lease manufacturing machine (M1) for a two-year period. The estimated useful economic live of the M1 at the start of the lease was five years. It was the responsibility of the lessor to repair and insure the M1. The lease contract stated that Venus Ltd should pay a deposit of ₹6,00,000 at the start of the lease followed by monthly payments of ₹2,00,000 in arrears.

The second contract was to lease another manufacturing machine (M2). The lease was for a four-year period, which was the estimated useful economic life of the machines. Venus Ltd is required to repair and insure the M2, which has no estimated residual value at the end of the lease. The lease rentals were set at ₹10,000 every six months, payable in advance. The rate of interest implicit in this lease was 5% per six-monthly period and the present value of the minimum lease payments was very close to the fair value of the assets at the inception of the lease, which was estimated at ₹70,000.
Show the necessary treatment in the financial statement for the year ended 31st March 20X2 of Venus Ltd in accordance of Ind AS 17.

Solution

Lease of machine M1

The first lease is for two years while the life of the manufacturing machine (M1) is five years, so this is an operating lease. Therefore the operating lease rentals should be charged to profit and loss account on a straight line basis per annum is ₹ 27,00,000 (6,00,000 + 24 x 2,00,000)/2

Lease of machine M2

The second lease is a finance lease as the lease period is equal to the economic life of the machines and the present value of minimum lease payment is close to the fair value of the assets.

An asset and liability is recognised at ₹ 70,000 being the present value of minimum lease payment is recognised.

<table>
<thead>
<tr>
<th>Period ended</th>
<th>Bal b/f</th>
<th>Payment</th>
<th>Bal in period</th>
<th>Interest (5%)</th>
<th>Bal c/f</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 September 20X1</td>
<td>70,000</td>
<td>(10,000)</td>
<td>60,000</td>
<td>3,000</td>
<td>63,000</td>
</tr>
<tr>
<td>31 March 20X2</td>
<td>63,000</td>
<td>(10,000)</td>
<td>53,000</td>
<td>2,650</td>
<td>55,650</td>
</tr>
<tr>
<td>31 September 20X2</td>
<td>55,650</td>
<td>(10,000)</td>
<td>45,650</td>
<td>2,283</td>
<td>47,933</td>
</tr>
</tbody>
</table>

Closing Liability:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liability (55,650-17,717)</td>
<td>37,933</td>
</tr>
<tr>
<td>Non-Current liability (20,000-2,283)</td>
<td>17,717</td>
</tr>
</tbody>
</table>

The total finance cost for the period is ₹ 5,650 (3,000 + 2,650)

3.7 SALE AND LEASEBACK TRANSACTIONS

- A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.
3.7.1 Finance Leasebacks

- If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term.
- If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, loss is not recognised unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with Ind AS 36.
- The transaction is merely a means by which the lessor provides finance to the lessee, with the asset as security.

3.7.2 Operating Leasebacks

- If a sale and leaseback transaction results in an operating lease, it is necessary to determine the fair value of the asset and compare this with the contract sale price. Because the sale and lease transactions are connected, the sale may have been arranged at other than fair value, with the impact of any difference being recognised in the rentals payable.
- The accounting treatment of operating leasebacks transaction is as follows:
  (a) If the sale price is equal to the fair value, there has, in effect, been a normal sale transaction and any profit or loss shall be recognised immediately.
(b) If the sale price is below the fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

(c) If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.

Accordingly 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 shall be recognised immediately.

3.7.3 Disclosure

Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.
Illustration 9

On 1st April 20X1 Earth Ltd sold a property it owned for ₹ 90 lakh and leased it back on a 10-year operating lease for rentals of ₹ 8 lakh per annum, payable on 31st March in arrears. The carrying value of the property in the financial statements of Earth Ltd at 1st April was ₹ 55 lakh and its market value on that date was ₹ 70 lakh.

Required:
Compute the amounts that will be shown in the financial statement for the year ended 31st March 20X2 in respect of the sale and leaseback.

Solution

Since the lease is an operating lease the property will be removed from the financial statements. A profit on sale of ₹ 15 lakh (₹ 70 lakh – ₹ 55 lakh) will be shown as other income in the statement of profit and loss. The rental expense of ₹ 8 lakh will be shown as an operating cost in the statement of profit and loss.

The difference of ₹ 20 lakh between the disposal proceeds (₹ 90 lakh) and the market value of the asset (₹ 70 lakh) will be shown as deferred income and released to the statement of profit and loss over the lease term of 10 years.

Therefore, ₹ 2 lakh (₹ 20 lakh x 1/10) will be credited to the statement of profit and loss in the year ended 31st March 20X2, probably as a reduction in operating costs. The remaining deferred income balance of ₹ 18 lakh (₹ 20 lakh – ₹ 2 lakh) will be included as a liability in the balance sheet. ₹ 2 lakh of this will be a current liability and ₹ 16 lakh (₹ 18 lakh – ₹ 2 lakh) will be non-current.

Illustration 9

The below facts are given for the Earth Heavy Movers Limited:

1. The lease is non-cancellable and is initiated on 1 April 20X1 for equipment with an expected useful life of five years.
2. Three payments are due to the lessor of the amount of 51,000 per year beginning 31 March 20X2. Included in the lease payments is a sum of 1,000, to be paid annually by the lessee for insurance.
3. The lessee guarantees a 10,000 residual value on 31 March 20X4 to the lessor.
4. Irrespective of the 10,000 residual value guarantee, the leased asset is expected to have only a 1,000 residual value to the lessee at the end of the lease term.
5. The Lessee company depreciates similar equipment that it owns on a straight-line basis.
6. The Fair value of the equipment at 1 April 20X1 is 1,32,000.
7. The Lessor’s implicit rate is 10%. This fact is known to the lessee company.
Requirements: As per provision of Ind AS 17: Leases,

1. How should lessee’s company classify and record the lease transaction at its inception on 1 April 20X1 (indicate journal entries)?

2. What are the journal entries the lessee is required to make to record the lease payments and the interest, insurance and depreciation expenses on 31 March 20X2 through 31 March 20X4?

3. What entry should the lessee make on 31 March 20X4 to record the guaranteed residual value payment (assuming an estimated residual value of 1,000) and to clear the lease related accounts from the lessee’s books?

4. What would be the Current and Non Current classification in the books of Lessee in year 1?

Solution

1. The Lessee company should record the asset as a finance lease as the risk and reward is being transferred and inspite of the fact the estimated residual value of the asset will be 1,000 still Lessee is guaranteed lessor residual value of ₹ 10,000. Further the lease payments substantially covers the fair value of leased asset as per calculation given below.

2. Calculation of Present value of Minimum Lease Payments (MLP)

   PV of MLP is calculated as per implicit rate of return of 10%

<table>
<thead>
<tr>
<th>Year</th>
<th>Discount Factor</th>
<th>Minimum Lease Payments (see note below)</th>
<th>Present Value of MLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Lease Rentals</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 March 20X2</td>
<td>0.909</td>
<td>50,000</td>
<td>45,450</td>
</tr>
<tr>
<td>31 March 20X3</td>
<td>0.826</td>
<td>50,000</td>
<td>41,300</td>
</tr>
<tr>
<td>31 March 20X4</td>
<td>0.751</td>
<td>50,000</td>
<td>37,550</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guaranteed Residual Value</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 March 20X4</td>
<td>0.751</td>
<td>10,000</td>
<td>7,510</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>1,31,810</td>
</tr>
</tbody>
</table>

Note: The Contingent rent, taxes, Insurance, Maintenance expenses etc if paid by the lessee to the lessor, then it does not form part of the Minimum lease payments and it will be expensed when
incurred. Hence in the above case, for calculation of Present value of Minimum Lease payments only lease rental of ₹ 50,000 has been considered.

At the time of Initial Recognition, the Lessee will recognise the Leasehold asset at lower of below:

Present value of MLP 1,31,810
Fair Value of Leased Asset 1,32,000
Hence, Leasehold asset will be recognised at 1,31,810

Accounting Entry for Recognition would be:

Leasehold Equipment Dr. 1,31,810
To Leasehold Obligation 1,31,810

Lease rentals should be split between Principal portion of leasehold obligation and finance costs. Same is computed in the below table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Payments</th>
<th>Finance Costs @ 10%</th>
<th>Reduction in Liability</th>
<th>Closing obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 April 20X1</td>
<td></td>
<td></td>
<td></td>
<td>1,31,810</td>
</tr>
<tr>
<td>31 March 20X2</td>
<td>50,000</td>
<td>13,181</td>
<td>36,819</td>
<td>94,991</td>
</tr>
<tr>
<td>31 March 20X3</td>
<td>50,000</td>
<td>9,499</td>
<td>40,501</td>
<td>54,499</td>
</tr>
<tr>
<td>31 March 20X4</td>
<td>50,000</td>
<td>5,501</td>
<td>44,499</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Entries at the time of Subsequent measurement at the reporting date:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>31 March 20X2</th>
<th>31 March 20X3</th>
<th>31 March 20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>Insurance Expenses</td>
<td>1,000</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Leasehold obligation</td>
<td>36,819</td>
<td></td>
<td>40,501</td>
</tr>
<tr>
<td>Interest Expenses</td>
<td>13,181</td>
<td></td>
<td>9,499</td>
</tr>
<tr>
<td>Depreciation</td>
<td>43,619</td>
<td></td>
<td>43,619</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>51,000</td>
<td></td>
</tr>
</tbody>
</table>
9.96  FINANCIAL REPORTING

<table>
<thead>
<tr>
<th>Accumulated Depreciation</th>
<th>43,619</th>
<th>43,619</th>
<th>43,619</th>
<th>43,619</th>
<th>43,619</th>
</tr>
</thead>
</table>

3. **Entries at the End of Lease period**

   Leasehold Obligation Account  Dr.  10,000
   Accumulated Depreciation Account  Dr.  1,30,810
   
   To Cash Account  9,000
   To Leasehold Equipment Account  1,31,810

4. The Current and Non-Current Classification at the end of year 1 in the books of Lessee is as follows:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non Current Asset</strong></td>
<td></td>
</tr>
<tr>
<td>Leasehold Asset</td>
<td></td>
</tr>
<tr>
<td>- Gross Block</td>
<td>1,31,810</td>
</tr>
<tr>
<td>- Accumulated Depreciation</td>
<td>(43,619)</td>
</tr>
<tr>
<td><strong>Non Current Liability</strong></td>
<td></td>
</tr>
<tr>
<td>Leasehold Obligation (payable after 12 months)</td>
<td>54,499</td>
</tr>
<tr>
<td><strong>Current Liability</strong></td>
<td></td>
</tr>
<tr>
<td>Leasehold Obligation (payable within 12 months)</td>
<td>40,501</td>
</tr>
</tbody>
</table>
### 3.8 SIGNIFICANT DIFFERENCES IN IND AS 17 VIS-À-VIS AS 19

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Particular</th>
<th>Ind AS 17</th>
<th>AS 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Land</td>
<td>Ind AS 17 does not have such scope exclusion. It has specific provisions dealing with leases of land and building applicable. Further, Ind AS 17 is not applicable as the basis of measurement for: - property held by lessees/provided by lessors under operating leases but treated as investment property and - biological assets held by lessees/provided by lessors under operating leases that are covered in the Standard on Agriculture.</td>
<td>AS 19 excludes leases of land from its scope. AS 19 does not contain such provisions.</td>
</tr>
<tr>
<td>2.</td>
<td>Definition of Residual Value</td>
<td>The definition of residual value has been deleted in Ind AS 17.</td>
<td>The definition of residual value appearing in AS 19 has been deleted in Ind AS 17.</td>
</tr>
<tr>
<td>3.</td>
<td>Initial Direct Costs:</td>
<td>The term ‘initial direct costs’ has been specifically defined in Ind AS 17 and definition of the term ‘interest rate implicit in the lease’ as per the AS 19 has been modified in Ind AS 17.</td>
<td>AS 19 does not define initial direct cost.</td>
</tr>
<tr>
<td>4.</td>
<td>Inception of Lease and Commencement of Lease</td>
<td>Ind AS 17 makes a distinction between inception of lease and commencement of lease. Further, Ind AS 17 deals with adjustment of lease payments</td>
<td>In AS 19, though both the terms are used at some places, these terms have not been defined and distinguished.</td>
</tr>
<tr>
<td>5. <strong>Treatment of Initial Direct Costs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treatment of initial direct costs under Ind AS 17 differs from the treatment prescribed under the existing standard.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance lease in the books of lessor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable; there is no need to add them separately.</td>
<td>Either recognised as expense immediately or allocated against the finance income over the lease term.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-manufacturer/Non-dealer</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating lease-Lessor accounting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Added to the carrying amount of the leased asset and recognized as expense over the lease term on the same basis as lease income</td>
<td>Either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognized as expense in the period in which incurred.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. <strong>Current/Non-current Classification of Lease Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ind AS 17 requires current/non-current classification of lease liabilities if such classification is made for other liabilities. Also, it makes reference to Ind AS 105, ‘Non-current Assets Held for Sale and Discontinued Operations’.</td>
<td>These matters are not addressed in AS 19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. <strong>Sale and Leaseback Transaction</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ind AS 17 retains the deferral and amortisation principle, it does not</td>
<td>As per AS 19, if a sale and leaseback transaction results in a finance lease,</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounting for Incentives in the Case of Operating Leases</td>
<td>Ind AS 17 provides guidance on accounting for incentives in the case of operating leases, evaluating the substance of transactions involving the legal form of a lease and determining whether an arrangement contains a lease.</td>
<td>AS 19 does not contain such guidance.</td>
</tr>
<tr>
<td>---</td>
<td>----------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>8.</td>
<td>Recognition of Lease Payments</td>
<td>Ind AS 17 requires that in case of operating lease, where escalation of lease rentals is in line with the expected general inflation so as to compensate the lessor for expected inflationary cost increases shall not be straight lined.</td>
<td>AS 19 does not provide for the same.</td>
</tr>
</tbody>
</table>
Practical Questions

1. X Ltd. took a machine on lease from Y 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 X Ltd. pays ₹ 3,00,000. X Ltd. has guaranteed a residual value of ₹ 22,000 on expiry of the lease to Y Ltd. However, Y 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 0.8696, 0.7561 and 0.6575 at the end of first, second and third years respectively.

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

2. A Ltd. agrees to enter into a new lease arrangement with B Ltd. B Ltd. agrees to a rent-free period for the first three years as incentive to the lessee for entering into the new lease. The new lease has a term of 20 years, at a fixed rate of ₹ 5,000 per year for years 4 through 20.

3. B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:
   (a) Lease period is 3 years, in the beginning of the year 20X1, for equipment costing ₹ 10,00,000 and has an expected useful life of 5 years.
   (b) The Fair market value is also ₹ 10,00,000.
   (c) The property reverts back to the lessor on termination of the lease.
   (d) The unguaranteed residual value is estimated at ₹ 1,00,000 at the end of the year 20X1.
   (e) 3 equal annual payments are made at the end of each year.
   (f) Consider IRR = 10%
   (g) The present value of Re. 1 due at the end of 3rd year at 10% rate of interest is Re. 0.7513.
   (h) The present value of annuity of Re. 1 due at the end of 3rd at 10% IRR is ₹ 2.4868.

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

4. X Ltd. sold JCB Machine having WDV of ₹ 50 Lakhs to Y Ltd. for ₹ 60 Lakhs and the same JCB was leased back by Y Ltd. to X Ltd. The lease is operating lease. Comment according to relevant Ind AS if:
   (a) Sale price of ₹ 60 Lakhs is equal to fair value.
   (b) Fair value is ₹ 50 Lakhs and sale price is ₹ 45 Lakhs.
   (c) Fair value is ₹ 55 Lakhs and sale price ₹ 62 Lakhs.
   (d) Fair value is ₹ 45 Lakhs and sale price is ₹ 48 Lakhs.
5. A Ltd. leases an asset to B Ltd. for its entire economic life and leases the same asset back under the same terms and conditions as the original lease. A Ltd. and B Ltd. have a legally enforceable right to set off the amounts owing to one another, and an intention to settle these amounts on a net basis. In this case, it should be accounted for as a single transaction. Whether the arrangement, in substances, involves a lease under Ind AS 17?

6. A Ltd. sells an asset to B Ltd. and leases the same asset back. B Ltd. is obligated to put the asset back to A Ltd. at the end of the lease period at an amount that has the overall practical effect, when also considering the lease payments to be received, of providing B Ltd. with a yield of LIBOR plus 2% p.a. on the purchase price. In this case, it should be accounted for as a single transaction. Whether the arrangement, in substances, involves a lease under Ind AS 17?

7. A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

   - The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.

   - The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.

   - The supplier is responsible for repairs, maintenance, and capital expenditures.

   - The supplier must stand ready to deliver a minimum quantity of gas each month.

   - Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.

   - If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Examine whether an arrangement contains a lease or not.

8. A manufacturing company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a specific component part of its manufactured product for a specified period
of time. The supplier designs and constructs a plant adjacent to the purchaser’s factory to produce the component part. The designed capacity of the plant exceeds the purchaser’s current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

- The supplier’s plant is explicitly identified in the arrangement, but the supplier has the right to fulfill the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomic.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity.
- The purchaser is required to pay a fixed price per unit for the actual quantity taken.
- Even if the purchaser’s needs are such that they do not need the stated minimum quantity, they still pay only for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market), so it is expected that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the supplier’s plant.

Examine whether an arrangement contains a lease or not.

**Answers to Practical Questions**

1. **Value of machinery**

The given case is of a finance lease because the lease term is equal to economic life of the asset. Here, fair value of the machinery is ₹ 7,00,000 and the net present value of minimum lease payments is ₹ 6,99,425 (refer note below). As the present value of the machine is less than the fair value of the machine, the machine will be recorded at value of ₹ 6,99,425.

**Note: Present value of minimum lease payments**

\[
= (\text{Annual lease rental} \times \text{PV factor}) + \text{Present value of guaranteed residual value}
\]

\[
= [\text{₹ 3,00,000} \times (0.8696 + 0.7561 + 0.6575)] + [\text{₹ 22,000} \times 0.6575]
\]

\[
= \text{₹ 6,84,960} + \text{₹ 14,465} = \text{₹ 6,99,425}.
\]
### Calculation of finance charges for each year

(Amount in ₹)

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Finance charge</th>
<th>Reduction in outstanding liability</th>
<th>Outstanding liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st year beginning</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>6,99,425</td>
</tr>
<tr>
<td>End of 1st year</td>
<td>3,00,000</td>
<td>1,04,914</td>
<td>1,95,086</td>
<td>5,04,339</td>
</tr>
<tr>
<td>End of 2nd year</td>
<td>3,00,000</td>
<td>75,651</td>
<td>2,24,349</td>
<td>2,79,990</td>
</tr>
<tr>
<td>End of 3rd year</td>
<td>3,00,000</td>
<td>41,998</td>
<td>2,58,002</td>
<td>21,988 *</td>
</tr>
</tbody>
</table>

* The difference between this figure and guaranteed residual value (₹ 22,000) is due to approximation in computing the interest rate implicit in the lease.

### 2.

Net consideration of ₹ 85,000 consists of ₹ 5,000 for each of 17 years in the lease term. Both A Ltd. and B Ltd. should recognise the net consideration of ₹ 85,000 over the 20 year lease term, i.e., ₹ 4,250 per year.

### 3.

#### Particulars

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of equipment</td>
<td>10,00,000</td>
</tr>
<tr>
<td>Unguaranteed residual value</td>
<td>1,00,000</td>
</tr>
<tr>
<td>Present value of residual value after third year @ 10% (₹ 1,00,000 × 0.7513)</td>
<td>75,130</td>
</tr>
<tr>
<td>Fair value to be recovered from lease payments (₹ 10,00,000 – ₹ 75,130)</td>
<td>9,24,870</td>
</tr>
<tr>
<td>Present value of annuity for three years</td>
<td>2,4868</td>
</tr>
<tr>
<td>Annual lease payment = ₹ 9,24,870/2.4868</td>
<td>3,71,912</td>
</tr>
</tbody>
</table>

The present value of lease payment i.e., ₹ 9,24,870 equals 92.48% of the fair market value, i.e., ₹ 10,00,000. As the present value of minimum lease payments substantially covers the initial fair value of the leased asset and lease term covers the major part of the life of asset, it constitutes a finance lease.
9.104  FINANCIAL REPORTING

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total lease payments (₹ 3,71,912 × 3)</td>
<td>11,15,736</td>
</tr>
<tr>
<td>Add: Unguaranteed residual value</td>
<td>1,00,000</td>
</tr>
<tr>
<td>Gross investment in the lease</td>
<td></td>
</tr>
<tr>
<td>Less: Net Investment, i.e., Present value of gross investment (lease payments and residual value) (₹ 75,130 + ₹ 9,24,870)</td>
<td>(10,00,000)</td>
</tr>
<tr>
<td>Unearned finance income</td>
<td>2,15,736</td>
</tr>
</tbody>
</table>

4. As per Ind AS 17, *Leases*:
   (a) Since sale price is equal to fair value, profit of ₹ 10 lakhs (i.e., ₹ 60 lakhs – ₹ 50 lakhs) is to be recognised as income immediately.
   (b) Assuming, the loss is not compensated by future lease payments at below market price, the loss of ₹ 5 lakhs (i.e., ₹ 50 lakhs – ₹ 45 lakhs) should be recognised immediately in the profit and loss account. In case, the loss is compensated by future lease payments at below market price, then the loss of ₹ 5 lakhs should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.
   (c) Profit of ₹ 7 lakhs (i.e., ₹ 62 lakhs – ₹ 55 lakhs) should be deferred and amortised over the period for which the asset is expected to be used. Profit of ₹ 5 lakhs (i.e., ₹ 55 lakhs – ₹ 50 lakhs) should be recognised immediately.
   (d) ₹ 3 lakhs (i.e., ₹ 48 lakhs – ₹ 45 lakhs) should be deferred and amortised over the period for which the asset is expected to be used. Loss of ₹ 5 lakhs (i.e., ₹ 50 lakhs – ₹ 45 lakhs) should be recognised immediately in the profit and loss account.

5. No. The terms and conditions and period of each of the leases are the same. Therefore, the risks and rewards incident to ownership of the underlying asset are the same as before the arrangement. Further, the amounts owing are offset against one another, and so there is no retained credit risk. The substance of the arrangement is that no transaction has occurred.

6. No. A Ltd.’s risks and rewards incident to owning the underlying asset do not substantively change. The substance of the arrangement is that A Ltd. borrows cash, secured by the underlying asset and repayable in instalments over the lease period and in a final lump sum at the end of the lease period. The terms of the option preclude recognition of a sale. Normally, in a sale and leaseback transaction, the risks and rewards incident to owning the underlying asset sold are retained by the seller only during the period of the lease.

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7. The arrangement contains a lease within the scope of Ind AS 17. An asset (the facility) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented in particular, that the facility is designed to meet only the purchaser’s needs and the supplier has no plans to expand or modify the facility - it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility’s output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

8. The arrangement does not contain a lease within the scope of Ind AS 17. An asset (the plant) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomic. However, the purchaser has not obtained the right to use the plant because the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and the likelihood that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the plant is more than remote, on the basis of the facts presented. In addition, the price that the purchaser pays is fixed per unit of output taken.