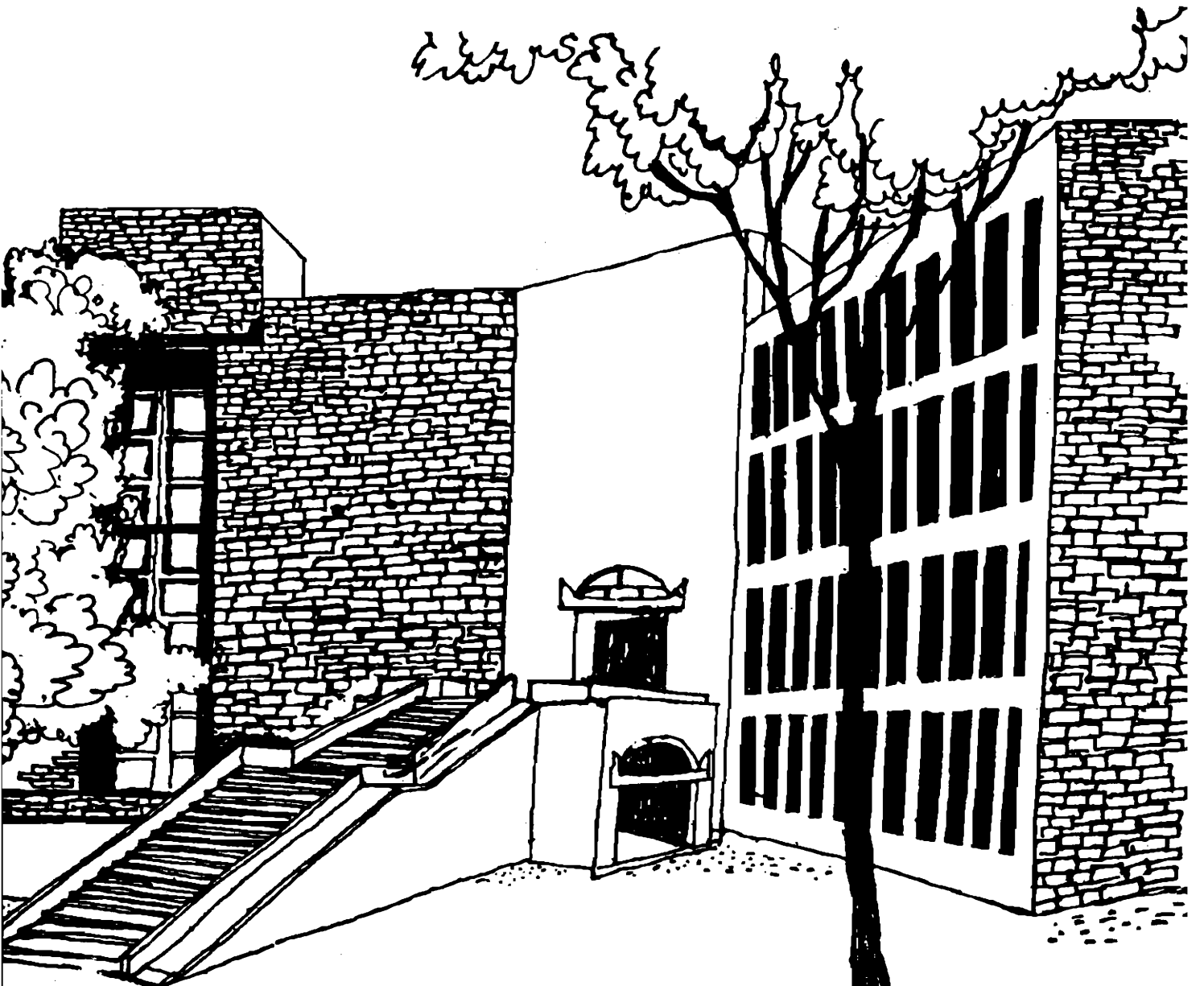




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LEASE ACCOUNTING PRACTICES IN INDIA

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LEASE ACCOUNTING PRACTICES IN INDIA*

Abstract

Accounting for leases is a debatable subject in spite of variety of standards having been issued by the professional accounting bodies all over the world. Two important issues relate to the treatment of lease rentals and the disclosure of leased assets in the financial statements. Opinions are divided whether leased assets should be replaced by lessees or lessors. The Indian position is also confused and divided. In this paper, we have provided an evaluation of the accounting standards followed in USA, UK, and the international accounting standards. We have also critically reviewed Exposure Draft and Guidance Note issued by the Institute of Chartered Accountants of India. A study of the practices of Indian companies with regard to the accounting of leases reveals the following: (a) operating method of treating lease rentals is followed; (b) leased assets are shown as own assets on historical basis in the balance sheets by leasing companies; (c) straight-line depreciation method is followed to depreciate the leased assets while written down value method is used in case of owned assets; (d) leased obligations are disclosed in footnotes by some lessees; (e) Indian companies consider leasing as an off-balance-sheet transaction; (f) Indian accounting practices are generally in line with legal prescriptions as under Indian Companies Act, 1956 and Income Tax Act, 1961.

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INTRODUCTION

Accounting for leases has been a controversial subject among the accountants, financial community, practitioners in leasing industry and accounting standards setters since the rise of the global popularity of leasing in the late 1950s and early 1960s. The reporting practices regarding leases have undergone a sea change over the past four decades, where once leases were neither disclosed nor, slowly they started getting reported in the notes to the accounts and even shown in the financial statements.

The main accounting controversy pertains to the lessees' financial statements. The dispute is in respect of charging of lease rentals to income and reporting of leased assets at its capitalized value in the balance sheet. Similarly, two important accounting issues in the case of lessor are the income recognition and disclosure of leased assets in the financial statements. The main reason for the controversy is the consideration of ownership of the leased assets. When ownership is considered on the basis of legal form, then lessor is the owner (de jure owner); but on the basis of financial and economic substance, the lessee, who bears the risks and rewards incidental to ownership is the owner (de facto owner). In countries like the USA, Australia, Germany and Japan, the ownership is recognised on the basis of economic substance and financial reality and hence the lessee retains the tax benefits of the assets. While in the UK, France, Sweden and India, the legal owner (lessor) of the asset is entitled to avail the tax benefit.

The primary objective of this paper is to examine the lease accounting practices of Indian leasing and lessee companies. For this purpose, we have analyzed the annual reports of leasing companies for a five-year period viz., from 1983-84 to 1987-88, and the lessee companies for three years viz., from 1985-86 to 1987-88. We have also analyzed information received through questionnaire from 28 leasing companies. Before presenting the empirical analysis, we have provided a brief review of lease accounting requirements under Financial Accounting Standard No.13 (USA), the Statement of Standard Accounting Practices No.21, (U.K.), International Accounting Standard No.17 and Exposure Draft and Guidance Note on "Accounting for Leases" by the Institute of Chartered Accountants of India. The main features of the lease capitalisation controversy is also presented.

LEASE ACCOUNTING STANDARDS

In this section, we provide an account of the U.S. standards, the U.K. standards and the international standards for the lease accounting.

THE U.S. STANDARDS

In the US, the Securities and Exchange Commission (SEC), was first to point out the emergence of the sale and lease back as a

major financing device and the accounting problems it created in its 15th Annual Report for the year ended June 30, 1949. Thereafter, efforts were made to develop standards of lease accounting by the accounting profession in the United States in October, 1949, when the leasing industry was still in its infancy. The Committee on Accounting Procedure of the American Institute of Certified Public Accountants issued Accounting Research Bulletins (ARB) No. 38 and No. 43 in this regard. A number of articles also appeared in the academic and business journals calling attention to the growing importance of leases and the related accounting issues. Some writers favoured the footnote disclosures whereas others favoured the capitalisation of leases in the financial statements of lessees. The major argument was whether the accountant should look through legal form of a transaction, or the financial substance of a transaction. During 1960s, accounting for leases, more particularly in the books of lessees, has been a much explored subject. For example, Myers (1962) advocated briefly that more information on lease was desirable in the financial statements either in the body of the statement or in a note. Gant R. Donald (1959), John L. Hennessy (1961), Robert W. Baltz (1960), and Gordon Shillinglaw (1958), strongly favoured the balance sheet reporting of leases (capitalisation of leases) while Alvin Zises (1961) and Donald C. Cook (1963) viewed against the capitalisation of leases. Accountants were not alone in considering this subject, the lawyers, economists, investment bankers, analysts and entrepreneurs also made their varying contributions.

The most comprehensive standard was put forth by the Financial Accounting Standard Board in November 1976, as its statement of Financial Accounting Standards No. 13, Accounting for Leases (FAS-13), which superseded Accounting Principles Board (APB) Opinion Nos. 5, 7, 27, 31 and paragraph 15 of the APB opinion No. 18. FASB Statement No. 13, "Accounting for Leases" and its various amendments and interpretations specified the accounting and reporting of leases by lessors and lessees.

The main thrust of the FAS-13 is whether a lessor has transferred substantially all the risks and rewards of ownership of the asset to the lessee, if so, the lease is considered as finance or capital lease. Accordingly, the lessee should record it as acquisition of an asset and incurrence of an obligation, while the lessor should account for it as a sale or financing. If the risks and rewards are not transferred, an operating lease results for both the lessee and the lessor.

What criteria could be applied to classify a lease either a capital lease or an operating lease? For a lessee, if a lease meets one or more of four of the following criteria, it is a capital lease; otherwise it is classified as an operating lease:

1. The lease transfers ownership of the property to the lessee by the end of the lease.
2. The lease contains a purchase option.

3. The lease term is equal to 75 per cent or more than the estimated economic life of the asset.
4. The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 per cent of fair value of the leased asset.

The lessee will account for the lease as follows:

1. A lessee records a capital lease as an asset and an obligation at an amount equal to the present value of the minimum lease payments.
2. The asset is amortized in a manner consistent with the lessee's normal depreciation policy.
3. Lease rentals are allocated between principal and interest over the lease term.
4. Under an operating lease, lease payments are charged as expenses usually on a straight line basis over the lease term.

The lessor in classifying leases also must apply the above stated four criteria and in addition, must meet both the following criteria:

1. Collectability of the minimum lease payments is reasonably predictable.
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor.

If these criteria are met, the lease is capitalised and classified as a direct financing, sales type or leveraged lease. The direct financing lease appears on the balance sheet as net investment, at the inception of the lease, equals to the cost or fair market value of the leased asset. Income is recognised to produce a constant rate of return on investment over the years.

THE U.K. STANDARD

The Accounting Standards Committee (ASC) of the UK, issued accounting standard for leases and hire purchase transactions, Statement of Standard Accounting Practice No. 21 (SSAP21), entitled "Accounting for Leases and Hire-Purchase Contracts" in August, 1984.

According to the Standard, a finance lease is one in which substantially all the risks and rewards of ownership of the asset are transferred to the lessee. Also the Standard suggests that where the present value of the minimum lease payments accounts to 90 per cent or more of the fair value of the asset then it is a finance lease. All other leases are operating lease.

From the lessor's point of view, for finance leases, income should be allocated so as to give a constant periodic rate of return on the net cash investment. The net investment in the finance lease should be shown as debtors in the balance sheet i.e., finance leases are treated as loans. For operating leases, the leases are shown as fixed assets and depreciated over their useful lives. The rental income should be reorganised on a straight line basis over the lease term.

As regards the accounting from the lessee's point, finance leases should be capitalised. The asset is depreciated in the same way as any other fixed asset. Operating leases are not capitalised, and rentals are charged on a straight line basis.

INTERNATIONAL STANDARDS

The International Accounting Standard No.17 (IAS-17) entitled "Accounting for Leases" was issued by the International Accounting Standards Committee (IASC) in September 1982. The Board of IASC presently consists of the professional accounting bodies of Australia, Canada, France, Germany, Italy, Ireland, Japan, Mexico, Netherlands, Nigeria, South Africa, Taiwan, the UK and the USA and the International Coordinating Committee of Financial Analysts Associations. About 60 countries are represented by IASB. Generally, compliance with International Standards is not required until the Standard is reflected in a national standard.

Like the U.S.A. lease accounting standard (FAS-13), the classification of leases adopted in the standard is based on the extent of risks and rewards incidental to ownership of a leased asset with the lessor or the lessee. The two parties, i.e., the lessor and lessee, will classify the lease in the same way. Whether a lease is a finance lease or not depends on the economic substance of the transaction rather than the form of contract. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership to the lessee. IAS-17 recommends the capitalisation of leases by lessees. The basic features of IAS-17 as related lessees are given below:

1. Lessees capitalise the leased assets under finance leases and depreciate the leased assets.
2. Lessees are required to apportion rentals between the finance charge and principal.
3. Under an operating lease, the charge to income should be the rental expenses for accounting period recognised on a systematic basis that is representative of the time pattern.
4. Lessees should disclose the amount of assets that are subject to finance leases at each balance sheet date

and liabilities relating to these leased assets are shown separately from other liabilities.

As regards lessors, IAS-17 prescribes the following:

1. A lessor should hold an asset under a finance lease in the balance sheet as a receivable and not as fixed asset.
2. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on investment.
3. Assets held for operating leases should be regarded as assets in the balance sheet and rentals should be recognised on a straight line basis over the lease term.
4. For operating leases, lessor depreciates the leased assets.

TOWARDS DEVELOPMENT OF LEASE ACCOUNTING STANDARDS IN INDIA

In the light of the growing importance of leasing in India since mid 1980s, a variety of accounting practices have been adopted by leasing companies. A number of leasing companies declared dividends out of capital from the very first year of operations. This has attracted the attention of the Institute of Chartered Accountants of India (ICAI) - a professional body regulating accounting profession in India. As such the Institute of Chartered Accountants of India issued an Exposure Draft (ED), "Proposed Guidance Note on Accounting for Leases" for public comments in February 1987. It is notable that most of the requirements in this Exposure Draft have been taken from IAS-17.

THE EXPOSURE DRAFT AND ITS CRITICISM

The requirements under Exposure Draft have some shortcomings which could render it unsuitable in its present form. Among others, the Equipment Leasing Association (ELA) of India, and the Association of Leasing, Finance and Housing Development Companies (LFH), have criticised it. According to them, Exposure Draft was quite complicated, lengthy, impracticable, irrational and unjustifiable. It was too harsh for infant and growing leasing industry. Both of the Associations had represented to the ICAI on the definition terms, classification of leases, principles of accounting for leases and accounting treatment and disclosure requirements. The following are the main points raised by the leasing industry:

1. The difficulty involved in determining the annual lease charge and application of internal rate of return in calculation of the implicit interest rate in the lease.

2. Need for postponing the recognition of income to the extent of uncertainty involved, which is the basic characteristic of leasing activity.
3. It would be sufficient to amortise the cost of equipment to the extent of 75 per cent of the cost of equipment, in view of the resale value and secondary period lease rentals under Exposure Draft (only guaranteed residual value is allowed to be taken as part of minimum lease payments).
4. Lease should be classified on terms such as a tax credit and grants to the lessor.
5. Accounting treatment and presentation in respect of leases should be governed by their legal form rather than their substance in the context of prevailing conditions.
6. The suggestions are based on pre-tax analysis and these are subject to income tax modifications.
7. The tax laws should allow the lessors to continue to claim depreciation and other allowances otherwise the guidelines will not be applicable.
8. It is not the right time to recommend a standard for infant leasing industry.
9. Disclosure requirements of lessors and lessees are neither practicable nor suitable.

The most of the criticisms in India are from the standpoint of the lessor, whereas in other countries they are from the lessees' point of view. The provisions of Exposure Draft are based purely on IAS-17 and SSAP-21, rather than the existing practices and Indian legal environment.

Exposure Draft gives rise to two problems in computing taxable income both for lessors and lessees from the published accounts. First, it is not clear whether tax authorities would accept the claims for lessee for deduction of lease rentals as per the Exposure Draft requirement. Second, as per the definition provided the lease includes hire-purchase contracts and stipulates the same treatment to both. In India, the hire-purchase contracts are governed and controlled by Indian Hire-purchase Act, 1972. The 1943 circular of the Central Board of Direct Taxes (CBDT) allows the hire-purchaser to claim the depreciation allowances. Exposure Draft could not recognise this fact at the time of its preparation. However, it was provided for in the Guidance Note issued subsequently.

The main recommendations of the ED are also not in line with other legislations in India. The provisions of the Indian Companies Act, 1956 could be violated by capitalising the leased

assets in the books of the lessee (non-owner) and not recording the assets by the lessor (owner). Again, another violation could be with regard to the provisions of Section 205 of the Companies Act in respect of depreciation on the assets.

In spite of the fact that ICAI has borrowed and adopted all the principles, and accounting treatment and disclosure requirements of accounting for leases mainly from IAS-17, and a few from FAS-13 and SSAP-21, it has overlooked the need for and importance of other types of transactions under leases. For example, it did not specify the accounting treatment for the lease management fee which is collected by almost all the leasing companies under lease contracts. Similarly, the sub-lease provisions and advance rentals have not been dealt with. Exposure Draft was also silent on the issues like sale and lease back contracts, vendor lease contracts, (i.e. leasing by manufacturers and dealers), leveraged leases and import or cross-border leasing.

GUIDANCE NOTE

In response to representations from the leasing industry and criticism by finance community, the Research Committee of the ICAI, after having discussions with the leasing associations, professionals in the leasing industry and others related to accounting aspects of leasing, modified some of the definitions, provisions and requirements of Exposure Draft. The ICAI issued a "Guidance Note on Accounting for Leases," in December 1988.

ICAI recognised the need for issuance of an accounting standard on accounting for leases with a view to establish sound accounting principles and practices in the leasing industry. It recognised that the existing accounting practices in leasing industry were mainly in accordance with the relevant provisions of the Income Tax Act, 1961 and Indian Companies Act, 1956. Therefore, it issued a Guidance Note as an interim measure. It is recommendatory in nature rather than mandatory. Guidance Note applies to all lease transactions entered into the accounting period beginning or after 1st April, 1989.

Guidance Note defines important terms as defined in the Exposure Draft. But a few definitions have been deleted and few others them have been modified. In Exposure Draft, finance lease was defined on the basis of transfer of substantially all the risks and rewards incidental to ownership. This definition was substituted by another based investment criteria. Guidance Note defined financial lease as the one under which the present value of minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset.

The following are the requirements of Guidance Note for the accounting treatment in the lessee's books:

1. Under finance lease, lessee should disclose the leased assets by way of a note to the accounts, disclosing

inter alia the future obligations of the lease as per the agreement. Lease rentals should be accounted for on accrual basis over the lease term so as to recognise an appropriate charge in this respect in the profit and loss account, with a separate disclosure thereof. The excess of the lease rentals paid over the amount accrued in respect thereof should be treated as prepaid lease rentals and vice versa.

2. Under an operating lease, rentals should be accounted for on accrual basis over the lease term so as to recognise an appropriate charge in this respect in the profit and loss account with a separate disclosure thereof. The lease rental payable over the lease term should be allocated on straight line basis irrespective of payments.

The following are guidances regarding the accounting of the financial leases in the lessor's books:

1. Assets leased should be disclosed as "Assets Given on Lease" under head "Fixed Assets" in the balance sheet. The classification of "Assets Given on Lease" should correspond to the method adopted in respect of other owned assets.
2. Lease rentals (those received and those due but not received) under a finance lease should be shown separately as "Lease Rentals" under "Gross Income" in the profit and loss account of the relevant period.
3. Against the lease rentals, a matching annual charge should be made to the profit and loss account. The annual lease charge should represent recovery of the net investment/fair value of the leased asset over the lease term. The annual lease charge would comprise (a) minimum statutory depreciation as per Companies Act 1956 and (b) lease equalisation charge, where the annual lease charge is more than the minimum statutory depreciation. Where annual lease charge is less than minimum statutory depreciation, a lease equalisation credit would arise. In this context, the following entries/disclosures should be made:
 - a. A separate "Lease Equalisation Account" should be opened with a corresponding debit or credit to "Lease Terminal Adjustment Account" as the case may be.
 - b. Lease Equalisation Account should be transferred every year to the profit and loss account and disclosed separately as deduction from/addition to gross value of lease rentals shown under the head "Gross Income".

- c. Statutory depreciation should be shown separately in the profit and loss account.
- d. Credit balance standing in Lease Terminal Adjustment Account at the end of the year should be shown under head "Current Liabilities" and debit balance should be shown under the head "Current Assets". At the end of the lease term, the balance standing in the "Lease Terminal Adjustment Account" should be transferred to the leased asset account and the same should be disclosed.
- e. Accumulated depreciation should be deducted from the original cost of leased asset. In the last year of the lease term, the balance in the "Lease Terminal Adjustment Account" should be shown as deduction from the book value of the asset arrived at as stated earlier.
- f. The net income should be recognised in respect of finance lease at a constant periodic rate of return on the lessor's net investment outstanding in the lease. The finance income for the period should be calculated by applying without rate implied in the lease during the relevant period.
- g. Initial direct costs such as commission and legal fees incurred in negotiating and arranging the lease should be expensed in the year in which they are incurred. Similarly, the management fee should be recognised in the year in which they accrue.

As regards operating leases, the following accounting treatment in the lessor's books has been suggested:

1. The asset held under operating lease should be treated by lessor as a fixed asset and rentals recoverable should be included in income over the lease term.
2. Costs including depreciation, incurred in earning the rental income, should be charged to income. Rental income should be recognised on a straight line basis which is representative of the time pattern of the earnings.
3. A leased asset should be depreciated on a basis consistent with lessor's normal depreciation policy for similar assets.
4. Initial direct costs incurred in negotiating and arranging lease should be expensed in the year in which they are incurred.

ISSUES IN THE CAPITALISATION OF LEASES

The Exposure Draft has stipulated that the lessee should show leased assets as owned assets and calculate depreciation on the leased assets. In other words, it has recommended capitalisation of leased assets in the books of lessee while the Guidance Note has provided that the lessee should only disclose assets taken under finance lease by way of a note to the accounts. It is obvious that the Exposure Draft has provided the accounting treatment on the economic substance and financial reality whereas the Guidance Note has provided accounting treatment on the legal form of ownership. This type of controversy exists all over the world.

There is considerable divergence of views on lease capitalisation across the world. As stated earlier, the countries such as Australia, Belgium, Canada, Ireland, the Netherlands, the United Kingdom, and the United States recognise that finance leases should be accounted for in accordance with their commercial substance (financial reality) in the financial statements of both of lessees and lessors. On the other hand, other countries such as France, Germany, Hong Kong, Italy, Japan, Norway, Sweden consider ownership on the basis of legal form.

Roger Chadder (1985) states that "the majority of the commercial substance countries are English speaking whilst many countries in the non-English speaking world prefer the legal form. This reflects a general tendency for English speaking countries to take the lead in accounting development."

The main arguments for the capitalisation of finance lease are summarized as follows:

1. Footnote disclosure
2. Lease commitments and property rights issues
3. Leasing frequently substitutes for borrowing
4. Unrecorded lease prevents adequate financial considerations.
5. Lease capitalisation is essential for their presentation
6. The question of substance over form.
7. International Accounting Standard No.17.
8. Improved comparability of accounts.

The following are the reasons against the capitalization of financial lease:

1. Commitments for future operating expenses are not liabilities.
2. Recognition of lease obligations may give rise to legal consequences.
3. Bankruptcy or reorganisation may reduce the lease obligations.
4. Reported lease obligations are arbitrary amounts.
5. Legal position of ownership is that of the lessor.

Hubbard (1980) conducted a questionnaire survey in the context of the U.K. lease capitalisation.. He had sent the questionnaire to the lessee sample of 1,000 members of ICMA members. Out of which 241 replies were received. The responses are given in Table 1.

TABLE 1

EMPIRICAL EVIDENCE FOR AND AGAINST LEASE CAPITALIZATION (U.K)

	Percentage agreed
<u>Arguments For</u>	
1. should show the assets in use, not assets in legal ownership	51
2. would more properly value the assets employed in the business	47
3. would improve the comparability of the accounts	44
4. would ensure consistency of the accounts	36
5. reliance on note disclosure is inadequate	19
<u>Arguments against</u>	
1. Assets do not legally belong to the company	56
2. Draws on arbitrary distinction between different types of leases	28
3. More information can be given by requiring disclosure in a note to the accounts.	25
4. Creates a precedent for future legal chances which may undermine leasing in the long run	11
5. Too difficult to precisely define and value finance leases	10

Source: Hubbard, Graham (1980), "Finance Leasing A Guide for the Lessees in U.K." p.46.

Even in India, the capitalisation controversy exists because the provisions of Companies Act 1956, Income Tax Act 1961, and Indian lease accounting practices are not in accordance with the capitalisation of leases. Presently, the accounting treatment and reporting are very simple even for finance leases in India. The Indian lessee companies neither capitalise nor disclose leased assets in footnotes. The lease

rental payments are charged to the profit and loss account as and when they are paid. The balance sheet of lessee ignores reporting of finance leases completely. The footnote disclosure is also not yet developed by the lessee industry. In other words, finance leases are treated as an off-balance sheet transaction. In India, the following may be arguments against capitalisation:

As per the lease contract, the ownership of the asset (title to the asset) never passes on to the lessee and the title remains with lessor. Therefore, on the face of the contract, the lessor is the legal owner (de jure owner) and lessee is the substance owner (de facto owner). Therefore, as per Section 32 of the Income Tax Act, 1961, lessee entitles neither for depreciation nor for any ownership benefits such as investment allowance/investment deposit scheme and rebates. Therefore, according to this argument, the leased assets should not be shown as owned assets in the balance sheet of lessee. Similarly, the provisions contained in part 1 of Schedule VI of the Companies Act 1956, will not allow the lessee to show the leased assets as owned assets, since lessee is not a legal owner of the asset.

LEASE ACCOUNTING PRACTICES OF COMPANIES IN INDIA

Irrespective of the controversy, what accounting practices are followed by lessors and lessees in India? This section attempts to answer this question. The results are based on the examination of annual reports¹ - balance sheet, profit and loss account, and their supported schedules and notes to the accounts as well as the 28 questionnaire responses. The questionnaire was designed on the basis of provisions contained in the Guidance Note on Accounting for Leases. The analysis of the questionnaire responses and annual reports is given in the following paragraphs.

LESSOR'S PRACTICES

Lease income: Presently, almost all leasing companies are recognising their income on accrual basis. But it has been observed from the analysis of responses that 14 (50 per cent) sample companies followed cash basis in their accounts upto March 31, 1988. Since the Companies Act was amended afterwards, it resulted in all the companies following the accrual basis of accounting.

1. 36 annual reports in 1983-84, 46 in 1984-85, 51 in 1985-86, 56 in 1986-87 and 61 in 1988 are analyzed.

Twenty (71 per cent) companies reported that they were following the operating method for treating the lease rentals in the financial statements. Operating method means the assets leased are treated as a fixed assets and the rentals receivable of the lease are recorded in the profit and loss account as rental income. The costs incurred in earning rental income, including depreciation on the assets leased are charged to the profit and loss account in that year. In other words, lease rentals are considered as an income item in the profit and loss account, without any bifurcation of lease rentals into principal and interest. No company has followed the finance method. Under finance method, lease rentals are split into two components i.e., repayment of principal and interest. Only interest portion would be credited to profit and loss account. Eight (28 per cent) companies did not respond to this question. It seems that about 30 per cent of the respondents did not know the conceptual differences between the operating and finance methods.

All sample companies reported that lease rentals were accounted for on accrual basis with month as a unit. Further, they stated that they used the two journal entries regarding lease rentals. On the due date of lease rentals, the lessee account will be debited and lease rental account will be credited.

The second entry is made at the time of receipt of lease rentals. Bank (or cash) account will be debited and the lessee account will be credited.

The important point to note is that, when the lease agreement provides for an uneven lease rentals, especially in the cases of front loaded (up front) or rear ended leases, or bell shaped, seasonal, or stepped, or deferred leases, it results into higher rentals in a particular period of time, and extremely less rentals in certain period. Therefore, the treatment of such lease rentals as income would not represent the time pattern. The primary issue for consideration is that whether lease rentals should be recognised in proportion to outstanding investment of the lessor during each year/period or on the basis of the net cash flow involved. These two methods are called investment period method and net of actuarial method.

Disclosure of lease rentals: An examination of lease rental disclosure in the profit and loss account indicated that 20 sample companies showed the "lease rentals" separately under the head "Income" in the profit and loss account. This type of disclosure is in accordance with the recommendations of the Guidance Note. Lease rentals and lease management fee were clubbed together and shown under the head "Income" in the profit and loss account by three sample companies. Four companies showed the income through lease rental with other income and shown separately as lease rentals in the schedule to profit and loss account. No specification of lease rental was given either in the profit and loss account or in the schedule to the profit and loss account by about 2 companies for

the years 1983-84 through 1985-86. This situation was corrected after 1986.

TABLE 2
NUMBER OF COMPANIES DISCLOSING LEASE RENTALS IN
THE PROFIT AND LOSS ACCOUNT

Description	Years				
	1983-84	1984-85	1985-86	1986-87	1987-89
1. Shown separately under head "Gross Income"	25 (70)	30 (65)	36 (71)	39 (70)	48 (79)
2. Shown with lease management fee	3 (8)	5 (11)	3 (6)	7 (12)	9 (15)
3. Included with other sources of income and separately shown in the schedule	6 (17)	8 (17)	8 (17)	10 (18)	4 (6)
4. No specification of lease rentals either in the Profit and loss account or in the schedule	2 (5)	3 (6)	4 (6)	-	-
TOTAL COMPANIES	36 (100)	46 (100)	51 (100)	56 (100)	61 (100)

Note : Figures in brackets indicate the percentages.

Short-term deposits : Fourteen (50 per cent) companies reported that short term deposits were shown under current liabilities, eight (29 per cent) stated that they considered them as short term unsecured loans and six (21 per cent) answered that they did not collect such deposits from the lessees. It is observed that majority of the sample companies showed short term deposits either as current liabilities or as short-term unsecured loans. As a consequence of this practice, the current and liquid ratios of pure leasing companies are likely to be less than that of the non-leasing companies.

Accounting for associated costs : Three companies did not respond to the question about the treatment of associated costs and six companies stated that they did not incur such costs. Fourteen (50 per cent) companies charged the associated costs such as commission and legal fees, often incurred by lessors in negotiating and consummating the lease, to the profit and loss account in the year in which the expenses are incurred on accrual basis (for earlier years, some companies followed cash method).

Three (11 per cent) companies wrote off the associated costs over the lease term, i.e., the costs were debited to profit and loss account during the primary lease period. Six (21 per cent) reported that they did not incur these costs while two companies responded that associated costs are debited to lessee account. Table 3 shows the accounting treatment of "associated costs" in the books of lessor.

TABLE 3
ACCOUNTING TREATMENT OF ASSOCIATED COSTS
BY LESSORS

Description	No. of companies	Percentage
1. Debited to profit and loss account	14	50
2. Written off during the primary lease period	3	11
3. Debited to lessee account	2	7
4. Non such costs	6	21
5. No response	3	11
TOTAL	28	100

It may be recalled that both the Exposure Draft and the Guidance Note have recommended that these initial costs normally would be expensed in the year in which they were incurred. It is observed that majority of the companies adopted practices in conformity with the requirements of Guidance Note.

Leased assets : All the sample companies showed leased assets as owned assets at cost less depreciation (on historical basis). But there were major variations as regards the mode of disclosure. Two companies (7 per cent) added the initial direct costs to the cost of leased equipment and 26 companies (93 per cent) at cost value in the balance sheet. A study of the annual reports of lessors for the years 1983-84 through 1987-88 has revealed the following practices.

It is observed that the extent of disclosure of leased assets and their classification has increased over years, viz. from 53 per cent of the companies in 1983-84 to 69 per cent in 1987-88. This was in line with the provisions of the Guidance Note. A few companies disclosed the leased assets without any classification and a few companies neither disclosed nor classified the leased assets. Table 4 shows the disclosure practices of leased assets by lessors.

TABLE 4

DISCLOSURE OF LEASED ASSETS BY LESSORS

No. of companies studied	Years				
	36	46	51	56	61
1. Leased assets were disclosed as "Assets on Lease" under the head "Fixed Assets" and classification of leased assets, as the method adopted for owned (non-leased) assets	19 (53)	30 (65)	36 (70)	38 (68)	45 (75)
2. Leased assets were disclosed as "Assets on Lease" but not supported by sub-classification of leased assets as classified the owned (non-leased) assets	4 (11)	5 (11)	2 (4)	8 (14)	9 (14)
3. Leased assets were neither disclosed nor classified	13 (36)	11 (24)	13 (26)	10 (18)	7 (11)
TOTAL COMPANIES	36 (100)	46 (100)	51 (100)	56 (100)	61 (100)

Disposal of leased assets : Disposal of assets results either in profit or loss. How do leasing companies treat this item? Seventeen respondents (60 per cent) reported that the profit and loss on disposal of assets were accounted for in the profit and loss account in the year of occurrence. Five (18 per cent) stated that they transferred it to the contingency reserve account, which was created for that purpose. Two companies (7 per cent) indicated that the terminal depreciation was absorbed at the end of the lease period and four (14 per cent) expressed that till now there were no such cases.

Assets in the secondary period : Eighteen (64 per cent) respondents reported that they recorded leased assets in the secondary period at the depreciated value, two (7 per cent) reported that assets were excluded from the balance sheet as these have no value. Eight (29 per cent) responded that the secondary period did not apply to them, since all the leases were in primary period.

Depreciation on leased assets : As stated above, all leasing companies reported the leased assets as "owned assets" in their financial statements under historical basis. Depreciation is a charge to the profit and loss account. The determination of quantum of depreciation was varied amongst the sample companies from year to year. It is observed from the study of the annual reports that a large number of leasing companies has adopted the straightline depreciation as per provisions of section 205 (2)(B) of the Companies Act. A few companies have adopted the depreciation policy in the light of the primary lease period, i.e., asset was written off during the primary period of the lease, and yet some companies have written off the assets like vehicles, computers and office equipment over five years. It is also observed that some companies adopted different methods for owned assets and leased assets. Table 5 reveals the depreciation policies of leasing companies.

About 80 per cent of the sample companies provided information about depreciation in the notes to the accounts. It is observed that there was an increase in the number of companies which disclosed the information about depreciation from 22 companies in 1983-84 to 60 companies in 1987-89. An analysis of the disclosures of depreciation methods indicated that 50 per cent of the sample companies (which disclosed the depreciation method) adopted straight line method (SLM) of depreciation for both non-leased (owned) and leased assets. About 5 per cent followed written down value (WDV) method for both non-leased (owned) and leased assets. One-fourth adopted straight line method (SLM) for leased assets and written down value (WDV) method for owned assets. Depreciation on leased assets has been written off equally over the effective period of lease by around seven per cent companies. During the years 1987-88 and 1988-89, a few more companies calculated depreciation at the rates derived from the corresponding rates under Income Tax Act and as per schedule XIV to the Companies Act.

TABLE 5
DEPRECIATION POLICIES OF LESSORS

Particulars	Years				
	1983-84	1984-85	1985-86	1986-87	1987-89
1.No. of companies provided the information about depreciation	22 (61)	31 (67)	46 (90)	51 (92)	60 (98)
2.Depreciation has been calculated on straight line basis on both non-leased (owned) assets and leased assets	10 (46)	18 (59)	28 (55)	28 (50)	26 (46)

Table 5 (contd.)

Particulars	Years				
	1983-84	1984-85	1985-86	1986-87	1987-89
3. Depreciation has been calculated on written down value basis on non-leased (owned) and leased assets	2 (9)	2 (6)	3 (5)	2 (4)	2 (3)
4. Depreciation has been calculated on written down value basis on non-leased (owned) assets and straight line method on leased assets	8 (36)	9 (29)	10 (19)	10 (18)	14 (24)
5. Depreciation on leased assets has been written off equally over the effective period of lease of each asset	2 (9)	2 (6)	4 (7)	4 (8)	4 (7)
6. Depreciation has been provided on certain leased assets at reduced rates based on the approval of the Central Government and in respect of other assets as per straight line method	-	-	5 (9)	4 (7)	3 (6)
7. Depreciation has been calculated in accordance with guidance provided in Circular No. 1/85 dated 10.01.1985 issued by Government of India	-	-	3 (5)	2 (4)	3 (6)

Table 5 (contd.)

Particulars	Years				
	1983-84	1984-85	1985-86	1986-87	1987-89
B. Depreciation on assets has been provided at rates derived from the rates providing corresponding rates under the Income Tax Act, 1961	-	-	-	5 (9)	4 (8)
TOTAL COMPANIES	22(100)	46(100)	51(100)	56(100)	61(100)

Note: 1. Figures in the brackets indicate percentages.

Rate of return on lease investment : Twelve (43 per cent) respondents reported that they recognised the lease charges as a constant periodic rate of return on the net investment outstanding in the lease. Sixteen (57 per cent) indicated that constant periodic rate of return on the net investment outstanding was not recognised while recognising the lease charge.

Interest rate implicit in the lease: Eight companies (29 per cent) stated that they used the interest rate implicit in the lease to calculate the finance income of the lease. Eighteen (64 per cent) responded that they did not use the interest rate implicit in the lease to calculate the finance income and two (7 per cent) did not respond.

Disclosure of important information : ICAI's Guidance Note has recommended that the lessor should disclose the accounting policies followed with regard to accounting for income under finance lease, valuation of assets given on lease and charge for depreciation.

As against this, 12 companies (43 per cent) disclosed the accounting policies followed with regard to income under the finance leases. Four (14 per cent) disclosed the information about the valuation of assets held under lease. Ten (35 per cent) disclosed the depreciation policy and the impact of change of depreciation on profit or loss in the notes to the accounts. It is understood that the rest of the companies did not change the depreciation policy since 28 respondents reported that they disclosed the change of depreciation method for leased assets and owned assets in the notes to the accounts. Ten companies disclosed the important accounting policies, methods of accounting and reorganising the lease income in the notes to the accounts.

LESSEES' PRACTICES

We have studied annual reports of 108 lessee companies for analysing their accounting practices and disclosures. The analysis indicates that only 26 (23 per cent) of sample companies disclosed the lease rentals separately as expense in the profit and loss account (directly in the profit and loss account or its schedule). These companies have variations in their presentations (see Table 6).

TABLE 6
DISCLOSURE OF LEASE RENTALS BY LESSEES

Description	No. of companies	Percentage
1. Lease rentals were disclosed as expense in the schedule to profit and loss account	13	50
2. Lease rentals were disclosed as expense in the schedule to profit and loss account and shown future rental obligations in the notes to the accounts	8	31
3. Lease rentals were disclosed as an expense in the profit and loss account and shown the future rental obligations as <u>Contingent Liabilities</u> in the notes to the accounts	5	19
	--- 26	--- 100

Further, two companies provided the lease rental as an item under the head "operating results" in the directors' report and one company furnished the lease rental in the statement of ten years performance at a glance.

It is understood from the analysis of the practices/disclosures of the lessee companies that the lease rentals are charged to profit and loss account as and when paid. This type of practice leads to the violation of matching concept when the lease rental structure is not in conformity with the economic use (benefit) of the leased asset. The uneven lease rental structure depends upon the nature of lease agreements, such as front loaded agreements, rear end agreements, balloon payments, variation clauses, and seasonal structured agreements. There is generally no indication either in the notes to the accounts or in the auditors' report about the treatment for prepaid rentals, advance rent

deposits and outstanding lease rentals. In this connection, the Guidance Note has suggested that lease rentals under finance lease should be accounted for on accrual basis over the lease term so as to recognise an appropriate charge to profit and loss account. This charge should be related to the terms and conditions of the lease agreement, type of asset and proportion of lease period to the life of the asset. The excess rentals paid over the amount accrued should be treated as prepaid lease rentals and vice versa.

The Guidance Note is silent on the classification of lease rentals in the profit and loss account. The lessee companies classified the lease rentals under different heads of expenses as shown in Table 7.

TABLE 7
CONSIDERATION OF LEASE RENTALS BY LESSEES

Description	No. of companies	Percentage
1. Manufacturing and other expenses	7	27
2. Manufacturing, administrative and selling expenses	8	30
3. Directly debited to profit and loss account	3	12
4. Administrative and other expenses	2	7
5. Stores consumed, salaries, wages and other expenses	1	4
6. Miscellaneous expenses	5	20
	--- 26	--- 100

It is noted that no company classified the lease rentals under the head of financial charges though leasing is considered to be a substitute for loan funds. Lease rentals are generally considered by the lessees in India as an operating expense either under manufacturing or administrative expenses.

It is significant to note that out of 108 lessee companies, no company had disclosed the particulars of leased assets, and the terms and conditions of the lease agreements.

CONCLUSION

Accounting for leases has been a controversial subject since rise of the global popularity of leasing in the late 1950s and early 1960s. The two main accounting issues are treatment of lease rentals (income recognition) and disclosure of leased assets (capitalisation) in the financial statements of lessees and lessors. Some of the lease accounting standards favoured capitalisation by lessee whereas some other favoured capitalisation by lessor. Most of the Indian leasing companies are following operating method for treating lease rentals in the financial statements. Leasing companies are showing leased assets as owned assets on historical basis in their balance sheets. Majority of leasing companies are depreciating leasing assets on straight line method and owned assets on written down value method. Lessee companies are also adopting operating method. Lessees disclose the lease obligations either in the footnotes or in the notes to the accounts. In India, leasing is considered as an off-balance sheet transaction. The review of Indian lease accounting practices indicates that these are in line with the legal form under Indian Companies Act, 1956 and Income Tax Act 1961.

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