LEASES

AS 19

INTRODUCTION

Meaning of Lease	✓ Lease means transfer of right to use assets for specified period against consideration/series of consideration.	
Parties in Lease	*Lessor*	✓ The party who transfers the asset is called 'Lessor'.
	Lessee	✓ The party to whom asset is transferred is called 'Lessee'.
Scope	*This Standard should be applied in accounting for all leases other than:* ✓ lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights ✓ licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights ✓ lease agreements to use lands	

TYPES OF LEASE

Finance Lease
A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred.
Deterministic Conditions: Atleast one of the following conditions must be satisfied to recognize the lease as Finance Lease
→ Transfer of ownership of the asset to the lessee by the end of the lease term.
→ Where lessee has purchase option at very reduced rate & lessee is certain to opt for purchase at inception.
→ Where lease period covers substantial period of economic life of asset.
→ 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 asset is of a specialised nature such that only the lessee can use it without major modifications being made.
Suggestive Conditions: Even if all the conditions are met – It does not necessarily imply that it is a finance lease.
→ If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee
→ If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease);
→ If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.
Operating Lease
A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

SOME IMPORTANT TERMS

Minimum lease payments	✓ These 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: ❖ in case of lessee, any residual value guaranteed by or on behalf of lessee or ❖ in the case of the lessor, any residual value guaranteed to the lessor: ▪ by or on behalf of the lessee ▪ by an independent third party financially capable of meeting this guarantee.
Fair Value	✓ It is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
Economic Life	✓ Economic life is either: ❖ the period over which an asset is expected to be economically usable by one or more users or ❖ the number of production or similar units expected to be obtained from the asset by one or more users.
Useful life	✓ Useful life of a leased asset is either: ❖ the period over which leased asset is expected to be used by the lessee, or ❖ the number of production or similar units expected to be obtained from the use of the asset by the lessee.
Residual Value	✓ Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.
Guaranteed residual value	✓ GRV is : ❖ in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (amount of the guarantee being the maximum amount that could, in any event, become payable) and ❖ in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.
Unguaranteed residual value	✓ Unguaranteed residual value of leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.
Gross Investment	✓ Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.
Unearned finance income	✓ Unearned finance income is the difference between: ❖ the gross investment in the lease and ❖ the present value of ▪ the minimum lease payments under a finance lease from the standpoint of the lessor and ▪ any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Net investment	✓ Net investment is gross investment less unearned finance income.
The interest rate implicit	✓ The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of ❖ the minimum lease payments under a finance lease from the standpoint of the lessor; and ❖ any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.
Lessee's incremental borrowing rate of interest	✓ It 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	✓ It is that portion of the lease payments that is not fixed in amount but is based on a factor other than just passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).
Non-Cancellable Lease	✓ a lease that is cancellable only: (a) upon the occurrence of some remote contingency; or (b) with the permission of the lessor; or (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain

LEASES IN FINANCIAL STATEMENTS OF LESSOR

Finance Lease

1. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.
2. The lessor should make the following disclosures for finance leases:
   a. a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years
      iii. later than five years
   b. unearned finance income
   c. the unguaranteed residual values accruing to the benefit of the lessor
   d. the accumulated provision for uncollectible minimum lease payments receivable
   e. contingent rents recognised in the statement of profit and loss for the period
   f. a general description of the significant leasing arrangements of the lessor
   g. accounting policy adopted in respect of initial direct costs.

Operating Lease

1. The lessor should present an asset given under operating lease in its balance sheet under fixed assets. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished

2. The lessor should, in addition to the requirements of AS 10, Property, Plant & Equipment and the governing statute, make the following disclosures for operating leases:
   a. for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
      i. the depreciation recognised in the statement of profit and loss for the period
      ii. impairment losses recognised in the statement of profit and loss for the period
      iii. impairment losses reversed in the statement of profit and loss for the period
   b. 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
      iii. later than five years
   c. total contingent rents recognised as income in statement of profit & loss for the period
   d. a general description of the lessor 's significant leasing arrangements
   e. accounting policy adopted in respect of initial direct costs.

LEASES IN FINANCIAL STATEMENTS OF LESSEE

Finance Lease

1. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease or present value of the minimum lease payments from the standpoint of the lessee whichever is lower.
2. The lessee should, in addition to the requirements of AS 10 (New), Property, Plant & Equipment and the governing statute, make the following disclosures for finance leases:
   a. assets acquired under finance lease as segregated from the assets owned
   b. for each class of assets, the net carrying amount at the balance sheet date
   c. a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years; (iii)
      iii. later than five years
   d. contingent rents recognised as expense in statement of profit and loss for the period
   e. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
   f. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
      i. the basis on which contingent rent payments are determined
      ii. the existence and terms of renewal or purchase options and escalation clauses
      iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Operating Lease

1. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.
2. The lessee should 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
   iii. later than five years
b. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
c. lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents
d. sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period
e. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   i. the basis on which contingent rent payments are determined
   ii. the existence and terms of renewal or purchase options and escalation clauses
   iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

SALE AND LEASEBACK TRANSACTIONS

1. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.
2. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.
3. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately.
   a. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.
   b. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no._____*

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease Term	4 Years
Fair value at inception of lease	₹ 20,00,000
Lease Rent	₹ 6,25,000 p.a. at the end of year
Guaranteed residual value	₹ 1,25,000
Expected residual value	₹ 3,75,000
Implicit interest rate	15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively. Calculate the value of the lease liability as per AS-19 & finance charges of each year.

Question 2 *(ICAI Study Material)* *Pg no._____*

Lessee Ltd. took a machine on lease from Lessor 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 Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However, Lessor 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 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.
Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.

Question 3 *(RTP Nov 2018) / (RTP May 2020)* *Pg no._____*

ABC Ltd. took a machine on lease from XYZ Ltd., the fair value being ₹ 10,00,000. The economic life of the machine as well as the lease term is 4 years. At the end of each year, ABC Ltd. pays ₹ 3,50,000. The lessee has guaranteed a residual value of ₹ 50,000 on expiry of the lease to the lessor. However, XYZ Ltd. estimates that the residual value of the machinery will be ₹ 35,000 only. The implicit rate of return is 16% and PV factors at 16% for year 1, year 2, year 3 and year 4 are 0.8621, 0.7432, 0.6407 and 0.5523 respectively. You are required to calculate the value of machinery to be considered by ABC Ltd. and the finance charges for each year.

Question 4 *(ICAI Study Material)* *Pg no._____*

Prakash Limited leased a machine to Badal Limited on the following terms:

Lease Term	5 Years
Fair value of Machine	₹ 28.3 Lakhs
Lease Rent per annum	₹ 8 Lakhs
Guaranteed residual value	₹ 1.60 Lakhs
Expected residual value	₹ 3 Lakhs
Internal Rate of Return	15%

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively. Ascertain Unearned Finance Income.

Question 5 *Pg no._____*

Jet Carriers Ltd. has initiated a lease for four years in respect of a vehicle costing ₹ 20,00,000 with expected useful life of 5 years. The asset would revert to the company under the lease agreement. The other information available in respect of lease agreement is:

1) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 2,50,000
2) The implicit rate of interest is 10%.
3) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hand of Jet Carriers Ltd.

a) The annual lease payment.
b) The unearned finance income.
c) The segregation of finance income.

(a) PV Residual value for 4 years @ 10% is 0.683. (b) PV Factor for 4 years @ 10% is 3.16987.

Question 6 *(ICAI Study Material)* Pg no._____

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 2019, 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 2021.
e) 3 equal annual payments are made at the end of each year.

The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513. The present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868. State whether the lease constitute finance lease & calculate unearned finance income. (Consider IRR = 10%.)

Question 7 Pg no._____

What do you understand by the term "Interest rate implicit on lease"? Calculate the interest rate implicit on lease from the following details:

Annual lease rent	₹ 80,000 at the end of each year
Lease period	5 Years
Guaranteed residual value	₹ 40,000
Unguaranteed residual value	₹ 24,000
Fair value at the inception of lease	₹ 3,20,000

Discounted rates for the first 5 years are as below:

At 10% 0.909, 0.826, 0.751, 0.683, 0621

At 14% 0.877, 0.769, 0.675, 0.592, 0.519

Question 8 *(RTP May 2022) (Similar)* Pg no._____

Classify the following into either operating lease or Finance lease:-

a) Ownership of the asset gets vested to the lessee at the end of lease term.
b) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.
c) Economic life of the asset is 7 years, lease term is 6.5 years, but the asset is not acquired at the end of the lease term.
d) Present Value (PV) of Minimum Lease Payment (MLP) = 'X'. Fair value of the asset is 'Y'
e) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for the use of the lessee.

Question 9 Pg no._____

Suppose outputs from machine taken on 3-year operating lease are estimated as 10,000 units in year 1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively.

Pass entries in books of lessee for 3 years.

Question 10 Pg no._____

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate. Calculate lease rentals and pass entries in books of lessor for 1st year.

Question 11 Pg no._____

On 1st January, 2020, Santa Ltd. sold equipment for ₹ 6,14,460. The carrying amount of the equipment on that date was ₹ 1,00,000. The sale was a part of the package under which Banta Ltd. leased the asset to Santa Ltd. for ten years term. The economic life of the asset is estimated as 10 years. The minimum lease rents payable by the lessee has been fixed at ₹ 1,00,000 payable annually beginning from 31st December, 2020. The incremental borrowing interest rate of Santa Ltd. is estimated at 10% p.a. Calculate the net effect on the Statement of profit and loss in the books of Santa Ltd.

Question 12 *(RTP Nov 2020) (May 2022) (Similar) / (ICAI Study Material)* Pg no._____

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs & the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹ 50 lakhs is equal to fair value.
(b) Fair value is ₹ 60 lakhs.
(c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.
(d) Fair value is ₹ 40 lakhs and sale price is ₹ 50 lakhs.
(e) Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs
(f) Fair value is ₹ 35 lakhs and sale price is ₹ 39 lakhs.

PRACTICE QUESTIONS

Question 1 Pg no._____

Annual lease rent = ₹ 80,000 at the end of each year
Lease period = 5 years Guaranteed residual value = ₹ 28,000
Fair value at the inception (beginning) of lease = ₹ 3,00,000
Interest rate implicit on lease is 12.6%. The present value factors at 12.6% are 0.89, 0.79, 0.7, 0.622, 0.552 at the end of first, second, third, fourth and fifth year respectively.
Show the Journal entry to record the asset taken on finance lease in the books of the lessee.

Solution

Journal entry in the books of Lessee

Particulars	L.F.	Dr.	Cr.
Asset A/c Dr.		2,99,776	
To Lessor			2,99,776
(Being recognition of finance lease as an asset and a liability)			

Working Note:

Year	Lease Payments	Discounting Factor (12.6%)	Present Value
1	80,000	0.89	71,200
2	80,000	0.79	63,200
3	80,000	0.70	56,000
4	80,000	0.622	49,760
5	80,000	0.552	44,160
5	28,000 (GRV)	0.552	15,456
			2,99,776

Question 2 *(Inter May 2019) (5 Marks) / (RTP Nov 2023)* Pg no._____

Jaya Ltd. took a machine on lease from Deluxe Ltd., the fair value being ₹ 11,50,000. Economic life of the machine as well as lease term is 4 years. At the end of each year, lessee pays ₹ 3,50,000 to lessor. Jaya Ltd. has guaranteed a residual value of ₹ 70,000 on expiry of the lease to Deluxe Ltd., however Deluxe Ltd. estimates that residual value will be only ₹ 25,000. The implicit rate of return is 10% p.a. and present value factors at 10% are: 0.909, 0.826, 0.751 and 0.683 at the end of 1st, 2nd, 3rd and 4th year respectively. Calculate the value of machinery to be considered by Jaya Ltd. and the value of the lease liability as per AS-19.

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of lessee, the amount recorded as an asset and a liability should be present value of minimum lease payments from standpoint of lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Lease Payments	Discounting Factor (10%)	Present Value
1	3,50,000	0.909	3,18,150
2	3,50,000	0.826	2,89,100

3	3,50,000	0.751	2,62,850
4	4,20,000 (3,50,000+70,000 GRV)	0.683	2,86,860
			11,56,960

Present value of minimum lease payments ₹ 11,56,960 is more than fair value at the inception of lease i.e. ₹ 11,50,000, therefore, the lease liability and machinery should be recognized in the books at ₹ 11,50,000 as per AS 19.

Question 3

Pg no._____

Sun Limited leased a machine to Moon Limited on the following terms:

Fair value at inception of lease	₹ 50,00,000
Lease Term	4 Years
Lease Rent per annum	₹ 16,00,000
Guaranteed residual value	₹ 3,00,000
Expected residual value	₹ 4,50,000
Implicit interest rate	15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively. Calculate the value of Lease Liability and ascertain Unearned Finance Income as per AS19

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Lease Payments	Discounting Factor (15%)	Present Value
1	16,00,000	0.8696	13,91,360
2	16,00,000	0.7561	12,09,760
3	16,00,000	0.6575	10,52,000
4	19,00,000 (16,00,000+3,00,000 GRV)	0.5718	10,86,420
			47,39,540

Present value of minimum lease payments i.e. ₹ 47,39,540 is less than fair value at the inception of lease i.e. ₹ 50,00,000, therefore, the value of lease is ₹ 47,39,540 and lease liability should be recognized in the books at ₹ 47,39,540 as per AS 19.

<u>Calculation of Unearned Finance Income</u>

As per AS 19 on Leases, unearned finance income is the difference between (a) the gross investment in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease. Where:

(a) Gross investment in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.
Gross investment = Minimum lease payments + Unguaranteed residual value
= [Total lease rent + Guaranteed residual value(GRV)] + Unguaranteed residual value(URV)
= [(₹ 16,00,000 x 4 years) + ₹ 3,00,000] + ₹ 1,50,000 = ₹ 68,50,000

(b) Present value of minimum lease payment from Lessor's view point lease liability
₹ 47,39,540 + present value of (URV) unguaranteed residual value (₹ 1,50,000 x 0.5718)
= ₹ 48,25,310

Unearned Finance Income = (a) – (b) = ₹ 68,50,000 – ₹ 48,25,310= ₹ 20,24,690

Question 4 *(RTP May 2018)/ (RTP Nov 2022) / (RTP May 2023)* Pg no._____

WIN Ltd. has entered into a three-year lease arrangement with Tanya sports club in respect of Fitness Equipments costing ₹ 16,99,999.50. The annual lease payments to be made at the end of each year are structured in such a way that the sum of the Present Values of the lease payments and that of the residual value together equal the cost of the equipments leased out. The unguaranteed residual value of the equipment at the expiry of the lease is estimated to be ₹ 1,33,500. The assets would revert to the lessor at the end of the lease. Given that the implicit rate of interest is 10%. You are required to compute the amount of the annual lease payment and the unearned finance income. Discounting Factor at 10% for years 1, 2 and 3 are 0.909, 0.826 and 0.751 respectively.

Solution

Computation of annual lease payment to the lessor

Cost of equipment	16,99,999.50
Unguaranteed residual value	1,33,500
Present value of residual value after third year @ 10% (₹ 1,33,500 × 0.751)	1,00,258.50
Fair value to be recovered from lease payments (₹ 16,99,999.5– ₹ 1,00,258.5)	15,99,741
Present value of annuity for three years is 2.486	
Annual lease payment = ₹ 15,99,741/ 2.486	6,43,500

Computation of Unearned Finance Income

Total lease payments (₹ 6,43,500 x 3)	19,30,500
Add: Unguaranteed residual value	1,33,500
Gross investment in the lease	20,64,000
Less: Present value of investment (lease payments and residual value) (₹ 1,00,258.5+ ₹ 15,99,741)	(16,99,999.50)
Unearned finance income	3,64,000.50

Question 5 Pg no._____

X Ltd. has leased equipment over its useful life that costs ₹ 7,46,55,100 for a three year lease period. After the lease term the asset would revert to the Lessor. You are informed that:

(i) The estimated unguaranteed residual value would be ₹ 1 lakh only.

(ii) The annual lease payments have been structured in such a way that sum of their present values together with that of the residual value of the asset will equal the cost thereof.

(iii) Implicit interest rate is 10%. You are required to ascertain the annual lease payment and the unearned finance income. Annual lease payments are made at the end of each accounting year. P.V. factor @ 10% for years 1 to 3 are 0.909, 0.826 and 0.751 respectively

Solution

Computation of annual lease payment to the lessor

Cost of equipment	7,46,55,100
Unguaranteed residual value	1,00,000
Present value of residual value after third year @ 10% (₹ 1,00,000 × 0.751)	75,100

Fair value to be recovered from lease payments (₹ 7,46,55,100 – ₹ 75,100)	7,45,80,000
Present value of annuity for three years is 2.486	
Annual lease payment = ₹ 7,45,80,000/ 2.486	3,00,00,000

Computation of Unearned Finance Income

Total lease payments (₹ 3,00,00,000 x 3)	9,00,00,000
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	9,01,00,000
Less: Present value of investment (lease payments and residual value) (₹ 7,45,80,000+ ₹ 75,100)	(7,46,55,100)
Unearned finance income	1,54,44,900

Question 6 Pg no._____

A machine having expected useful life of 6 years, is leased for 4 years. Both the cost and the fair value of the machinery are ₹ 7,00,000. The amount will be paid in 4 equal instalments and at the termination of lease, lessor will get back the machinery. The unguaranteed residual value at the end of the 4th year is ₹ 70,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 4th year at 10% IRR is 3.169. The present value of ₹ 1 due at the end of 4th year at 10% rate of interest is 0.683. State with reasons whether the lease constitutes finance lease and also compute the unearned finance income

Solution

Determination of nature of lease

Fair value of asset ₹ 7,00,000

Unguaranteed residual value ₹ 70,000

Present value of residual value at the end of 4th Year = ₹ 70,000 x 0.683 = ₹ 47,810

Present value of lease payment recoverable = ₹ 7,00,000 - ₹ 47,810 = ₹ 6,52,190

Percentage of present value of lease payment to fair value of asset is

= (₹ 6,52,190/₹7,00,000)x100 = 93.17%

Since it substantially covers the major portion of lease payment and life of the asset, the lease constitutes a finance lease

Calculation of Unearned finance income

Annual lease payment = ₹ 6,52,190 / 3.169 = ₹ 2,05,803 (approx.)

Gross investment in the lease = Total minimum lease payment + unguaranteed residual value.

= (₹ 2,05,803 x 4) + ₹70000

= ₹ 8,23,212 + ₹70,000

= ₹ 8,93,212

Unearned finance income = Gross investment – Present value of minimum lease payment and unguaranteed residual value.

= ₹ 8,93,212 – ₹ 7,00,000 (₹ 6,52,190 + ₹ 47,810) = ₹ 1,93,212

Question 7 *(RTP May 2019)* Pg no._____

Aksat International Limited has given a machinery on lease for 36 months, and its useful life is 60 months. Cost & fair market value of the machinery is ₹ 5,00,000. The amount will be paid in 3 equal annual installments and the lessee will retune the machinery to lessor at termination of lease. The unguaranteed residual value at the end of 3 years is ₹ 50,000. IRR of investment is 10% and present value of annuity factory of ₹ 1 due at the end of 3 years at 10% IRR is 2.4868 and present value of ₹ 1 due at the end of 3rd year at 10% IRR is 0.7513.

You are required to comment with reason whether the lease constitute finance lease or operating lease. If it is finance lease, calculate unearned finance income.

Solution

Determination of Nature of Lease

Present value of unguaranteed residual value at the end of 3rd year = 50,000 x 0.7513 = 37,565

Present value of lease payments = ₹ 5,00,000 – ₹37,565 = ₹ 4,62,435

Percentage of present value of lease payments to fair value of asset

= (₹ 4,62,435/ ₹ 5,00,000) x 100 = 92.487%.

Since, lease payments substantially covers the major portion of the fair value; the lease constitutes a finance lease.

Calculation of Unearned Finance Income

Annual lease payment = ₹ 4,62,435/ 2.4868 =₹ 1,85,956 (approx.)

Gross investment in the lease = Total minimum lease payments + unguaranteed residual value

= (₹ 1,85,956 × 3) + ₹ 50,000

= ₹ 5,57,868 + ₹ 50,000 = ₹ 6,07,868

Unearned finance income = Gross investment – Present value of minimum lease payments and unguaranteed residual value

= ₹ 6,07,868 – ₹ 5,00,000 = ₹ 1,07,868

Question 8 *(RTP Nov 2019) / (RTP May 2021)* *Pg no.*_____

Sun Limited wishes to obtain a machine costing ₹30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Star Ltd., for a lease rental for₹3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise. (Use annuity factor at @ 15% for 5 years as 3.36)

Solution

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment amounts to at least substantially all of the fair value of leased asset.

In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as

Annuity factor (Year 1 to Year 5)	3.36 (approx.)
Present Value of Minimum Lease Payments (₹ 3 Lakh each year)	₹ 10.08 Lakhs (approx.)

Thus, present value of minimum lease payments is ₹10.08 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease.

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

Question 9 *(RTP Nov 2020) (Similar) / (ICAI Study Material)* *Pg no.*_____

Classify the following into either operating lease or Finance lease:-

a) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.
b) Economic life of the asset is 7 years, lease term is 6 years, but the asset is not acquired at the end of the lease term.
c) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for the use of the lessee.
d) Present Value (PV) of Minimum Lease Payment (MLP) = 'X'. Fair value of the asset is 'Y'

Solution

a) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.
b) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
c) Since the asset is procured only for the use of lessee, it is a finance lease.
d) The lease is a finance lease if X = Y, or where X substantially equals Y.

Question 10 *(Inter Nov 2019) (5 Marks)* Pg no._____

Classify the following into either operating lease or finance lease with reason:

(1) Economic life of asset is 10 years, lease term is 9 years, but asset is not acquired at end of lease term.
(2) Lessee has option to purchase the asset at lower than fair value at the end of lease term.
(3) Lease payments should be recognized as an expense in the statement of Profit & Loss of a lessee.
(4) Present Value (PV) of Minimum Lease Payment (MLP) = "X". Fair value of the asset is "Y". X = Y.
(5) Economic life of the asset is 5 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee.

Solution

(1) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
(2) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.
(3) It is an operating lease under which lease payments are recognized as expense in the profit and loss account of lessee to have better matching between cost and revenue.
(4) The lease is a finance lease if X = Y, or where X substantially equals Y.
(5) Since the asset is of special nature and has been procured only for the use of lessee, it is a finance lease.

Question 11 *(ICAI Study Material)* Pg no._____

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost ₹ 1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years.

Straight line depreciation in proportion of output is considered appropriate. Compute the following:

(i) Annual Lease Rent
(ii) Lease Rent income to be recognized in each operating year and
(iii) Depreciation for 3 years of lease

Solution

(i) Annual lease rent

Total lease rent

$$= 130\% \text{ of ₹ } 1{,}50{,}000 \times \frac{\text{Output during lease period}}{\text{Total Output}}$$

= 130% of ₹ 1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 +70,000)

= 1,95,000 x 1,50,000 units/3,00,000 units = ₹ 97,500

Annual lease rent = ₹ 97,500 / 3 = ₹ 32,500

(ii) Lease rent Income to be recognized in each operating year

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.

Hence income recognised in years 1, 2 and 3 will be as:

Year 1 ₹ 26,000, Year 2 ₹ 32,500 and Year 3 ₹ 39,000.

(iii) Deprecation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40:50:60:80:70.

Depreciation for year 1 is ₹ 20,000, year 2 = 25,000 and year 3 = 30,000.

Question 12 *(Inter Dec 2021) (5 Marks)* Pg no._____

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost of ₹ 2,25,000. Economic life of the machine is 5 years and output from the machine is estimated as 60,000 units, 75,000 units, 90,000 units, 1,20,000 units and 1,05,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. You are required to compute the following as per AS-19.

a) Annual Lease Rent

b) Lease Rent income to be recognized in each operating year and

c) Depreciation for 3 years lease

Solution

a) Annual lease rent

Total lease rent = 130% of ₹ 2,25,000 × Output during lease period/ Total output

= 130% of 2,25,000x (60,000 +75,000+ 90,000)/(60,000 + 75,000 + 90,000 + 1,20,000 + 1,05,000)

= 2,92,500 x 2,25,000 units/4,50,000 units = ₹ 1,46,250

Annual lease rent = ₹ 1,46,250 / 3 = ₹ 48,750

b) Lease rent Income to be recognized in each operating year

Total lease rent should be recognized as income in proportion of output during lease period, i.e. in the proportion of 60,000 : 75,000 : 90,000 or 4:5:6

Hence income recognized in years 1, 2 and 3 will be as:

Year 1 ₹ 39,000, Year 2 ₹ 48,750 and Year 3 ₹ 58,500.

c) Depreciation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 2,25,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 60 :75: 90 : 120 : 105 .

Depreciation for year 1 is ₹ 30,000, year 2 = 37,500 and year 3 = 45,000.

Question 13 *(Inter May 2018) (5 Marks)* Pg no._____

A Ltd. sold JCB having WDV of ₹ 20 lakhs to B Ltd. for ₹ 24 lakhs and the same JCB was leased back by B Ltd. to A Ltd. The lease is operating lease. In context of Accounting Standard 19 "Leases" explain the accounting treatment of profit or loss in the books of A Ltd. if

(i) Sale price of ₹ 24 lakhs is equal to fair value.

(ii) Fair value is ₹ 20 lakhs and sale price is ₹ 24 lakhs.

(iii) Fair value is ₹ 22 lakhs and sale price is ₹ 25 lakhs.

(iv) Fair value is ₹ 25 lakhs and sale price is ₹ 18 lakhs.

(v) Fair value is ₹ 18 lakhs and sale price is ₹ 19 lakhs

Solution

Following will be the treatment in the given cases:

(i) When sale price of ₹ 24 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹4 lakhs (i.e. 24 – 20) in its books.

(ii) When fair value is ₹ 20 lakhs & sale price is ₹ 24 lakhs then profit of ₹ 4 lakhs is to be deferred and amortised over the lease period.

(iii) When fair value is ₹ 22 lakhs & sale price is ₹ 25 lakhs, profit of ₹ 2 lakhs (22 - 20) to be immediately recognised in its books and balance profit of ₹3 lakhs (25-22) is to be amortised/deferred over lease period.

(iv) When fair value of leased machinery is ₹ 25 lakhs & sale price is ₹ 18 lakhs, then loss of ₹ 2 lakhs (20 – 18) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment.

(v) When fair value is ₹ 18 lakhs & sale price is ₹ 19 lakhs, then the loss of ₹ 2 lakhs (20-18) to be immediately recognised by A Ltd. in its books and profit of ₹ 1 lakhs (19-18) should be amortised/deferred over lease period

Question 14 *(Inter Jan 2021) (5 Marks) / (ICAI Study Material)* *Pg no._____*

X Ltd. sold machinery having WDV of ₹ 300 lakhs to Y Ltd. for ₹ 400 lakhs and the same machinery was leased back by Y Ltd. to X Ltd. The lease back arrangement is operating lease. Give your comments in the following situations:

(i) Sale price of ₹ 400 lakhs is equal to fair value.

(ii) Fair value is ₹ 450 lakhs.

(iii) Fair value is ₹ 350 lakhs and the sale price is ₹ 250 lakhs.

(iv) Fair value is ₹ 300 lakhs and sale price is ₹ 400 lakhs.

(v) Fair value is ₹ 250 lakhs and sale price is ₹ 290 lakhs.

Solution

Following will be the treatment in the given cases:

(i) When sale price of ₹ 400 lakhs is equal to fair value, X Ltd. should immediately recognise the profit of ₹100 lakhs (i.e. 400 – 300) in its books.

(ii) When fair value is ₹ 450 lakhs then also profit of ₹100 lakhs should be immediately recognised by X Ltd.

(iii) When fair value of leased machinery is ₹ 350 lakhs & sales price is ₹ 250 lakhs, then loss of ₹ 50 lakhs (300 – 250) to be immediately recognised by X Ltd. in its books provided loss is not compensated by future lease payment.

(iv) When fair value is ₹ 300 lakhs & sales price is ₹ 400 lakhs then, profit of ₹ 100 lakhs is to be deferred and amortised over the lease period.

(v) When fair value is ₹ 250 lakhs & sales price is ₹ 290 lakhs, then the loss of ₹ 50 lakhs (300-250) to be immediately recognised by X Ltd. in its books and profit of ₹ 40 lakhs (290-250) should be amortised/deferred over lease period.

Question 15 *(Inter May 2022) (5 Marks)* *Pg no._____*

What are the disclosures requirements for operating leases by the lessee as per AS-19?

Solution

As per AS 19, lessees are required to make following disclosures for operating leases:

a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:
   (i) not later than one year;
   (ii) later than one year and not later than five years;
   (iii) later than five years;

b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;
c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;
d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;
e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   (i) the basis on which contingent rent payments are determined;
   (ii) the existence and terms of renewal or purchase options and escalation clauses; and
   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.