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ACCOUNTING FOR LEASES - COMPARISON OF INDIAN ACCOUNTING STANDARD AND US GAAP

The comparison of lease accounting as per the Indian GAAP (AS-19) US GAAP SFAS-13 is based on –

(1) The similarities between these two GAAPs
(2) Significant differences between two GAAPs

SIMILARITIES BETWEEN AS-19 AND SFAS-13 (US GAAP)

Definition of the lease- Definition of lease as given in AS-19 and SFAS-13 is almost similar.
SFAS-13, defines the lease as right to use property (tangible or intangible) for a specified time period from the lessor who owns it by paying a rental fee. Although title is not transferred the lease may in some cases transfer substantial risks and benefits of ownership. Theoretical substance comes before legality in accounting so that the lessee in a capital lease arrangement will have to record as asset and related liability. Other leases are simply a rental of property. Leases may be structured to derive certain tax benefits.

AS-19, defines lease as an arrangement by which the lessor give the right to use an asset for given period of time to the lessee on the rent. The lease transactions derive its accounting complexity from number of alternative available to the parties involved. Lease can be structured to take tax benefit. They can be used for transfer ownership of the leased asset, and they can be used to transfer the risk ownership. In any event substance of transaction dictates the accounting treatment; the lease transaction (finance lease) is probably the best example of the accounting profession's substance over legal form. If the transactions effectively transfers ownership to lessee then the substance of the transactions is that of a sale and should be recognized as such even through transactions takes form of a lease.

Definitions of the important terms -Definitions of following important terms are almost similar in AS-19 and SFAS-13

- Lease term
- Fair value of leased property
- Minimum lease payments
- Estimated economic life of the lease property
- Estimated residual value
- Related party in leasing transactions
- Inception of lease
- Initial direct costs
- Contingent rent
- Interest rate implicit in the lease

Lease Classification -As per AS-19 for the purpose of the accounting we classify the lease into two categories as follows:

(a) Finance lease
(b) Operating lease

(a) Finance Lease- It is a lease which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership. In following situations the lease transactions are called as finance lease-

- The lessee will get the ownership of leased asset at the end of the lease term
- The lessee has an option to buy the leased asset at the end of terms at price which is lower than its expected fair value at the date on which option will be exercised
- The leased term covers the major part of the life of asset
- At the beginning of lease term present value of minimum lease rental covers the initial fair value
- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification

(b) Operating Lease- It is a lease which does not transfer substantially all the risks and rewards incidental to ownership. Classification of lease is made at the inception of the lease if at any time the lessee and lessor agree to change the provision of lease and it result in different category of lease it will be treated separate agreement.

As per SFAS-13 from the standpoint of lessee, leases is classified into two types (Similar as AS-19) –

(a) Capital lease
(b) Operating lease

(a) Capital Lease- Capital lease is similar to finance lease as per AS-19. A capital lease exists if any one of the following four criteria exists -

- The lessee is to get property ownership at the end of the lease term. This criterion is still satisfied if ownership is transferred shortly after the end of the lease term
- A bargain purchase option exists in which the lessee can either buy the property at a minimum amount or renew the lease at very low rental payments relative to the "going rates"
- The lease term is 75% or more of the life of the property
- The present value of minimum lease payments at the start of lease equals or exceeds 90% of the fair market value of the property. Minimum lease payments do not include executory costs to be paid by the lessor, which are being reimbursed by the lessee. Examples of such costs are property taxes, insurance and maintenance.

(b) Operating Lease- In an operating lease, there is a regular rental of property. In such a case, rent expenses are charges as incurred under the accrual basis? The credit is either to payables or cash. Rent expense is usually reflected on a straight-line basis over the lease term even if the payments are not on a straight-line basis.

Example of finance lease (AS-19) and Capital Lease (SFAS-13)

AS-19

R Ltd. (lessee) acquired machinery on lease from S Ltd. (the lessor) on January 1, 2000. The lease term covers the entire economic life of the machinery i.e. 3 years. The fair value of the machinery of 1st January 2000 is Rs. 350,000. The lease agreement requires the lessee to pay an amount of Rs. 150,000 per year beginning 31st December 2000. The lessee has guaranteed a residual value of Rs. 11,400 on 31st December 2002 to the lessor. The lessor however estimates that the machinery will have a salvage value of only Rs. 10,000 on 31st December 2002. The implicit rate of interest is 15% per annum. Compute the value of machinery to be recognized by the lessee and also the finance charges every year on the basis of AS-19. P.V. Factor of 15% in three years is 2.283.

As per paragraph 11 of AS-19, at the inception of a finance lease, the lessee should recognize 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 lease. However, if the fair value of leased asset exceeds the present value of minimum lease payments from the standpoint of the lessee, the Amount recorded, as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee. In this case fair value of the machinery Rs. 350,000 and the net present value of minimum lease payment from the standpoint of lessee is also Rs. 3,50,000 (approximately). As the net present value of minimum lease payment is not less than the fair value then the machinery will be recognised by the lessee at Rs. 350,000.

Present value of minimum lease payment =

Annual lease rental x P.V. factor + Present value of guaranteed residual value
= 150,000 X (0.8695+ 0.7561 +0.6575) +11,400 x 0.6575
= 342,465 + 7,496 = 349,961
Rounded off to 350,000

Year	Outstanding liability	Finance Charges	Payment	Reduction in outstanding liability
1st year	(Jan 1) 350,000	--	--	--
	(Dec31) 252,500	52,500	150,000	97,500
2nd year	(Dec31) 140,375	37,875	150,000	112,125
3rd year	(Dec 31) 11,431	21,056	150,000	128,944

SFAS-13

Example 1: On Jan 1,2003 the lessee engages in a capital lease for property. The minimum lease payment is $ 30,000 per year for six years payable at year-end. The interest rate is 5%. The present value of an ordinary annuity factor for N=6, I=5% is 5.0757. The journal entries for the first two years are as follow:

01.01.2003

Asset	152,271	
Liability		152,271

$30,000 x 5.0757 = $152,271

31.12.2003

Interest Expenses	7,614	
Liability	22,386	
Cash		30,000

5% x $ 152,271 =$ 7,614

Depreciation Expenses	25,379	
Accumulated depreciation		25,379

The liability as on 31.12.2003 is

31.12.2003	Paid	22,386	01.01.2003	152,271
31.12.2003	Balance	129,885		

31.12.2004

Interest Expenses	6,494	
Liability	23,506	
Cash		30,000

5% x $ 129,885 =$ 6,494

Depreciation Expenses	25,379	
Accumulated depreciation		25,379

Example 2: NDA Corp. enters into a 10-year capital lease on a building on December 31, 2002. Leasing payments of $ 62,000, which include real estate taxes of $ 2,000 are due annually beginning December 31, 2003 and every December 31, thereafter for the lease term. NDA Corp. does not know the interest implicit in the lease but its (NDA Corp's) incremental borrowings rate 10%. The rounded present value of an ordinary annuity for 10 years at 10 % is 6.1. What amount should NDA Corp report as capitalized lease liability at December 31, 2002?

The problem indicates that this lease is a capital lease. In addition, since payments are due at the end of the period (year), we are dealing with an ordinary annuity. The question is to determine the initial lease liability of the lessee. In order to compute this number, we must calculate the present value of the minimum lease payments discounted at the incremental borrowing rate since the implicit rate in the lease is not known. In general, we choose the lessee's incremental borrowing rate. However, the implicit rate in the lease is substituted if it is known and it is lower than the incremental rate.

Capitalized leased liability = minimum lease payment x present value of an ordinary annuity of one year for 10 years at 10% =($ 62,000-$ 2,000) x 6.1 = $ 60,000 x 6.1 =$ 366,000

NDA Corp., the lessee, should report the capitalized lease liability as $ 366,000

Example 3: X Ltd. leased a machine for 10 years its useful life and agreed to pay $ 25,000 at the start of the lease term on December 31, 2001. As part of the agreement, it was also required to continue such payments each December 31, for the next nine years. The present value on December 31, 2001 of the 10 lease payments over the lease term, using the implicit rate of the interest known to X Ltd of 8% is $ 181,250. The present value of the lease payments using X Ltd's incremental borrowing rate of 10% is $ 169,000. X Ltd. made timely second lease payments. What amount should X Ltd. report as its capital lease liability in its December 31, 2002 balance sheet? In this problem, it is stated that the lease is a capital lease. In addition, because the lessee is making all lease payments at the beginning of the period, the lease represents an annuity due. Also, since the implicit rate in the lease is known and it is lower than X Ltd incremental rate(10%), the discount rate that should be used is 8% rate. Therefore, X Ltd should originally record the capitalized lease (long-term asset and liability) at $ 181,250. this amount was derived in the following way:

The present value of minimum lease payments = $ 25,000 x present value of 1 for 10 years at 8% = $ 25,000 x 7.25 = $ 181,250)

Present value of minimum lease payments on 31.12.2001		= $ 181,250
Less: Payment on 31.12.2001		25,000
Liability balance (31.12.2002)		$ 156,250
Less: Payment on 31.12.2002	$ 25,000	
Less: Portion of payment applicable to interest during 2002		
$ 156,200 x 8%	$ 12,496	$12,504
Capital lease on December 31, 2002		$143,746

Applicability -Both the standards agree that the statements be applied in accounting for all leases other than –

- Lease agreements to explore for or use natural resources, such as oil, gas, timber, mental and other mineral rights; and
- Licensing agreements for item such as motion pictures film, video recordings, plays, manuscripts, patents and copyrights.

SIGNIFICANT DIFFERENCES BETWEEN THE TWO GAAPS

Finance Lease/Capital Lease- Finance lease referred to as capital lease under US GAAP is based on four specific tests. The classification under AS is based substantial transfer of risks and rewards of ownership. The AS-19 approach differs from that adopted by the corresponding US standard, SFAS-13, in that more subjective criteria are established by AS-19. In the US standard, a threshold of 75% or more of the useful life has been specified for classifying a lease as a finance lease, which thus creates a "bright line" test to be applied mechanically, the corresponding language under AS-19 stipulates that capitalization results when the lease covers a "major part of the economic life" of the asset. Further a threshold of "the present value of minimum lease payments equaling at least 90% of lease asset fair value" is set under the US standard, rather than the "substantially all of the fair value of the leased asset" employed under AS-19.

Different Classification of the Lease -US GAAP clearly sets forth the circumstances or factors which if not satisfied from the standpoint of the lessor would lead to different classifications by the lessor and the lessee. SFAS-13, stipulates that the following two conditions both need to be satisfied in addition to meeting any one of the criteria established for standpoint of a lessor: -

- Collectibility of the minimum lease payments is reasonably predictable
- No important uncertainties surround the amount of non-reimbursable costs yet to be incurred by the lessor under the lease.

Under US GAAP, therefore, if a lease transaction does not meet the criteria for classification as: -

- A sales-type lease
- A direct financing lease,
- Leveraged lease as specified above (by satisfying both of the above noted extra criteria), it is to be classified in the financial statements of the lessor as an operating lease. If the lessee has accounted for the lease as a capital lease, the asset being leased may appear on the balance sheet of both lessee and lessor. However AS-19 does not clearly set out the criteria when the lessor and lessee can differently classify the same lease although it relates "differing circumstances" leading to the same lease being classified differently by the lessor and lessee.

Lease of land - According to AS-19, lease agreements to use land does not come under the purview of statement but SFAS includes such agreements by virtue of its definition.

Sale and Lease Back -Under US GAAP, the provisions relating to sale and lease back are different. If the lease meets one of the criteria of capital lease, the seller lessee shall account it as a capital lease, otherwise as an operating lease. Any profit or loss on the sale shall be deferred and amortized in proportion to the amortization of the leased asset, if a capital lease, or in proportion to the related gross rental charges to expense over the lease term, if an operating lease, unless-

- The seller lessee relinquishes the right to substantially all of the remaining use of the asset sold (only minor portion (10%) retained), in which case the sale and lease back shall be accounted as separate transactions based on their respective terms. However, where lease rentals are unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued by adjusting the profit or loss on sale and amortized as stated above to adjust those rentals to a reasonable amount.
- The seller lessee retains more than a minor (10%) but less than substantially all of the use of the asset through the leaseback and realizes a profit on sale in excess of (i) the present value of the minimum lease payments over the lease term, if the lease back is classified as an operating lease, or (ii) classified as capital lease. In that case, profit on sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale.

Discount Rate -Under AS-19, for the purpose of capitalization of the lease in the lessee books, the interest rate used to compute the present value should be the lessee's incremental borrowing rate unless it is practicable to determine the rate implicit in the lease, in which case that rate should be used. It is interesting to note that under US GAAP, in order to use the rate implicit in the lease to discount the minimum lease payments, this rate must be lower than the lessee's incremental borrowing rate. Logically, of course, if the lessee's incremental borrowing rate were lower than a rate offered implicitly in a lease, and the prospective lessee was aware of this fact, it would be more attractive to borrow and purchase, so the US rule may be somewhat superfluous. The AS-19 does not set this a condition.

Certain Specified Criteria - There are certain special situations, which are addressed by US GAAP and not addressed by AS-19 such as –

- Sublease
- Termination of a lease
- Reversal or extension of an existing lease
- Leases between related parties
- Accounting for leases in business combination
- Accounting for changes in lease agreement resulting from refunding of tax exempt debt
- Sale or assignment to third parties - non recourse financing
- Wrap lease transactions
- .money over money lease transactions
- lease involving government units.