Leasing Business and Accounting Practices

By

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Nature of Leasing Business

Leasing in India is essentially restricted to *Equipment Leasing* which is defined as :

> "A contract between a Lessor and Lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the Lessee. The Lessor retains the ownership of the asset, the Lessee has possession and use of the asset on payment of specified rentals over a period."

This definition is in line with the basic concept of leasing which presupposes that it is the use and not ownership that generates profits. Leasing, in fact, is a contractual, legally enforceable obligation between two parties namely the Lessee—the person who wants to use an equipment and the Lessor—the person who purchases the equipment according to the specification or requirement of the Lessee and gives it to the latter for use at an agreed rent over a specified period of time. Leasing is, therefore, the use of an asset which belongs to somebody else. The *right to own* and the *right to use* an asset are differentiated in a leasing transaction. It is the most distinguishing feature of equipment leasing which has created a new sector in the economy wherein industrial assets are *owned* by leasing companies which are mostly in the nature of financial institutions while they are *used* by manufacturing concerns who are in a position to employ these assets in a productive manner.

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Leasing is essentially an alternate source of finance for bussiness units especially in India where economic conditions are favourable for encouraging this sophisticated method of financing. For meeting Capital expenditure, in connection with an outright purchase of equipment, for diversification or expansion or both, the business units have to mobilise funds by means of internal generation and/or by raising from the market and/or by approaching financial institutions like I D B I and Commercial Banks. But due to well known constraints such as inflation, heavy taxation and diseconomies of operation, a majority of corporate entities have limited internal sources to finance heavy capital equipment costs. Funds raising through market channels is confined to only selected band of industrial groups. In addition, it involves considerable initial expenditure in the form of issue costs, underwriting commission etc. with uncertainty about the results. Financial institutions, no doubt, provide funds at a comparative low cost but the procedural formalities are time consuming. Leasing overcomes these hurdles. It is quick financing service with Lessor accepting all the problems on behalf of the Lessee. It should be emphasised that a Lease is not the same thing as a *sale* because there is continuing relationship between the parties. It is also different from *hire purchase* which is really in the nature of sale on instalment with the ultimate objective of transferring the ownership to the hire purchaser.

FINANCIAL OR FULL PAY OUT LEASE

It is defined as a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred. In financial lease, the lessee decides what equipment he wants to buy and also the vendor or manufacturer who sells the same. Leasing Company places an order for the same with 100 per cent financing. The Lessor, thus, pays for the equipment and thereafter remains the owner of it. All maintenance and insurance charges are on the Lessee's account. The rental paid by the Lessee is expected to take care of the capital cost of the equipment, the Lessor's expenses, interest on the money and Lessor's margin of the profit. When the equipment is delivered, the Lessor and the Lessee enter into a Non-Cancellable Lease Agreement for a fixed period of time called the *primary period* depending upon the useful economic life of the equipment. This primary period is generally of five years except for very big contracts when the period may be longer, within which the equipment cost is fully amortised and Lessor recovers close to hundred per cent of his investment alongwith his on the same. Upon the expiry of the primary period, two options are available to the Lesser generally, that is, (i) the contract may be got renewed perpetually at a nominal rental (pepper corn rentals) for whatever period of time he desires. This is known as *secondary* and sometimes indefinite period; (ii) the equipment may be returned to the Lessor. After the expiry of the primary period, the Lessor is not much concerned either in the value of the asset or the problem of obsolescence as he has already recovered his investment and margins. The Lessor, however, has to ensure that the primary period is not more than the useful economic life of the asset. It is a period of risk during which the Lessor still has substantial funds outstanding under the contract and in case the rental is not paid by the Lessee, the Lessor can recoup the losses only from the unexpired cost of the asset.

OPERATING OR NON-PAY OUT LEASE

In this type of leasing, the asset will be leased over and over again for short periods to different users. The primary lease rentals do not cover the cost and profit margins of the Lessor and the assets are normally released to recover their full value including profit margins. In other words, the cost of an asset is not recovered from any single Lessee. The maintenance burden is on the Lessor and the latter undertakes to bear the maintenance expenses, insurance expenses, insurance charges and manufacturing overheads associated with the leased equipment, which is purchased by the Lessor and the Lessee is allowed to use the same over the lease period. Operating lease is a very popular method for introducing innovative products and developing the market for the same. Examples are : computers, air-crafts, cold-storage plants etc.

There are other leasing arrangements as well such as sale and lease back, leveraged lease etc. But from the point of view of accounting practices as they prevail in India and other countries, the foregoing two types—Financial and Operating Leases are generally recognised by accounting profession.

ACCOUNTING PRACTICES

Accounting is generally referred to as the language of the business which provides quantitative information primarily financial in nature. Accounting, therefore, must be adapted to the requirements of these users who have a right to know about the affairs of the Company, e.g. shareholders, creditors, managers, government and, of course, general public. The financial information sought must be such as to enable the analysist to determine the solvency, profitability, risk and efficiency aspects of a business enterprise. In sum, it means lease transactions must be fully disclosed and properly recorded in the books of accounts for the benefit of the interested groups An improper presentation or concealment of leased assets and rentals and also inappropriate depreciation charge would not only be misleading but are contrary to the basic tenets of accounting.

NON-DISCLOSURE OF LEASED ASSETS AND FUTURE RENTAL OBLIGATIONS

Lessee Companies (Companies which have taken assets on lease) in India invariably do not record the asset taken on lease anywhere in any book of account. Rental payments are recorded only when they are actually paid and the amount is debited to the income statement in the year of actual payment, thus ignoring the disclosure of future rental obligations. Part I of the Schedule VI of the Companies Act 1956, requires a company to disclose the contingent liabilities only—as a footnote to the Balance Sheet. There is no reference to an asset taken on lease. However, a leasing transaction from the point of view of Lessee introduces both the *asset content* and *liability of* a contingent nature. It is an *asset* as it represents future economic benefits and a *liability* since tha lessee is under obligation to make rental payments during the primary period in the first instance and in the secondary or indefinite period at a later stage. Incidentally it is not clear whether a Lease transaction is covered by Schedule VI of the Companies Act. Though there is a *prima facie* indication about the liability aspect may be as a foot note only, the treatment of asset aspect is completely missing Non-disclosure of such a vital information amounts to gross injustice to the users of financial information.

The reluctance of the corporate sector to disclose the asset content could be traced to the regulatory framework which encourages '*off the balance sheet transactions*'. For example, a leasing transaction is a convenient mode of by-passing the provisions of Monopolies and Restrictive Trade Practices (MRTP) Act which defines the concentration of economic power in terms of the value of the assets employed as reflected in the books of accounts of a business unit. In case the value of the assets exceeds 100 crores, the company attracts the provisions of the Act. Thus, it is safe to employ the asset without owning it and escape from the web of the MRTP Act.

Further, the regulatory provisions draw a distinction between small scale industries and others purely on the basis of the assets employed (i.e. owned) by a business unit as reflected in balance sheet. An asset taken on lease, therefore. need not be capitalised to circumvent various measures of the Government.

The corporate entities can also minimise the amount of total liabilities by entering into a leasing agreement instead of owning the asset.

CAPITALISING THE ASSET

It is true that the basic postulate of leasing transaction is the *use* and not the *ownership*—no legal title to ownership but only right to use. A *Financial Lease* as stated above is a full pay out or a non-cancellable lease agreement by virtue of which the Lessee makes the rental payments upto the useful economic life of the asset and total rental payments exceed the cost of the asset to the Lessor. In most of the cases, the lease agreement also provides in option to purchase the asset on the expiry of the lease period on payment of a nominal sum and this option is made certain on the date of signing the lease agreement itself. The leasing companies call it as a moral commitment. In economic terms these features put the leasing of an asset at par with the purchasing of an aaset with the technical difference in the legal sense. There is, therefore, a strong case for capitalising the asset in the financial statements in respect of *financial lease*.

RECOGNITION OF FUTURE RENTAL PAYMENTS

In addition to the asset content of a Financial Lease, arrangement, it is logical to examine the liability aspect of the future rental payments. Lease financing is, in essence, a form of *debt financing*. For every debt to finance an asset, be it issue of debentures or other long term loans, the borrower has to refund not only the *principal sum* but also interest alongwith it. The principal sum of the debt is treated as liability and appropriately classified as secured/unsecured loans in the balance sheet. The interest element is classified as *charge* against the profits like an operating expense. The refund on account of principal sum would automatically reduce the liability content without debiting profit and loss account. Cost of the asset is recovered through depreciation charge. If such be the situation, the charging of rental payments against the income of the year in which these are paid is clearly contrary to the fundamental rule of accounting which requires only revenue expenses to be charged to income so as to achieve proper matching of costs against revenues. The interest payment is essentially a *revenue payment* and repayment of principal sum is a *capital transaction*.

It is not disputed that in legal terms the leasing contract is *executory* in nature and the liability on this account is not determinable in terms of absolute amount and the Lessee is only user and not the owner. But keeping in view the stake of the users of the financial information for decision making, it is important to accord supermacy to the economic substance over legal form. This is exemplified by the fact that if one were to be guided strictly by the legality of the lease transactions, then the accounting of financial leases would not be substantially different from that of accounting of operating lease. The rentals payable under an operating lease can be charged to the income of the year in which these are paid since the lease is normally for a shorter period and revocable by. the Lessee by giving the Lessor due notice. The *focus* is on the operating conditions, that is, whether the asset is needed or not and whether the asset is according to the prescribed requirements and *not* how to finance the same. The magnitude of the impact of the financial lease decision is far greater than that of an operating lease decision.

THE NECESSITY FOR FULL DISCLOSURE

It is amply clear that the Lessee companies must disclose '*asset* and *liability* contents' of the lease transactions in the balance sheet and must distinguish the rental payments in terms of capital and revenue payments in the income statement. Such a classified disclosure would provide useful financial information to the creditors, investors and other users for decision making. It may be emphasised that weightage must be given to the economic impact of the disclosure over the legal requirements. "If the financial reports are to fulfil their objective of providing useful information to the users than substance of the transactions should take precedence over the form. The depicting of financial reality should be the primary considerations and not the technical niceties of a transaction (like the financial lease agreement being the executory contract). These observations have relevance in the sense that exclusion of financial lease transactions by strict adherence to legal form would distort the computation of certain ratios such as Debt-equity ratio, Assets-Turnover ratio and Coverage ratio which are employed by the users to evaluate the financial conditions and performance of a corporate entity,

LESSOR'S METHODS OF ACCOUNTING

It is reported that in our country the entire *lease rental* is accounted as income and not split into repayment of *principal* and *interest* portions. This practice is undoubtedly against the basic method of measuring the income. Not only this, the method of depreciation has a significant impact on the reported income. The depreciation on straight line method at the corresponding *Written Down Value Rate* of 15 per cent and 30 per cent will write off only 16.95 per cent and 59.40 per cent of the cost of the asset respectively in the first five years—the usual primary lease period. It would leave a balance depreciation of 83.05 per cent and 40.60 per cent respectively to be written off in the subsequent secondary period. Thus there is a strong case for recovering the full depreciation during the primary lease period going by the substance of the transaction. Such a practice of recovering full depreciation during the primary period only would satisfy the criterion of matching concept since the income is generally very insignificant in the secondery period.

LACK OF GUIDELINES-MAIN TROUBLE SPOT

The *root cause* of varying accounting practices resulting in the misreporting or distorted presentation of income figure and financial position by leasing companies is the absence of statutory and professional guidelines in this regard. The Finance Minister has recently hinted that the comprehensive guidelines were underway. It is high time that the Institute of Chartered Accountants of India evolves a uniform accounting system for leasing companies which is essential for fledgling industry like leasing to ensure its orderly growth. "Lessors the world over have been innovative creatures and this innovation extends to financial accounting in the absence of clear cut accounting practices. The same problem is reflected in the accounts of Lessee Companies too with only a limited number of lessees indicating present or future rentals in their accounts. It is the responsibility of the accounting profession to ensure that the accounting practices are such as would enable disclosure of true financial position and performance since they have the responsibility of certifying the truthfulness and correctness of the company's accounts. Unfortunately there is neither any opinion (exposure draft) or any standard from our professional institute. It is true that there is an International Accounting Standard (I.A.S.) 17 and the accounting standards issued by professional bodies in U.S.A. (F A.S.B. 13) and U.K. (S.S.A.P. 21) but confusion still persists. The reason is to be found in the complexity of the guidelines as well as inapplicability of some elements in our country.

INTERNATIONAL ACCOUNTING STANDARD (I.A.S) 17 : ACCOUNTING FOR LEASES

(A) Account of Lessees.

(i) A finance lease should be reflected in the balance sheet of Lessee by recording an asset and a liability at amounts equal at the inception of the lease to the lower of :

(a) the fair valve of the leased property net of grants and tax credits receivable by the Lessor; or

(b) the present value of the minimum lease payments using the interest rate implicit in the lease.

(ii) Rentals should be apportioned between finance charge and reduction of outstanding liability. The finance charge should be allocated on a base, which during the lease term, produces a constant periodic rate of interest on the remaining balance of liability. Some form of approximation (e.g. sum of the digits) may be used.

(iii) The depreciation policy for leased assets should be on a basis consistent with that for assets which are owned outright.

If there is no reasonable certainty that Lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.

(Note : In the U.K. the Lessee never obtain legal title)

(iv) Operating leases—the charge to income should be the rental expense for the accounting period.

(B) Account of Lessor

(i) Finance Leases

(I) An asset held as a finance lease should be recorded in the balance sheet *not* as property, plant and equipment but as a receivable at an amount equal to the net investment in the lease.

(2) Subject to prudence considerations, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either :

(i) the Lessor's net investment outstanding; or

(ii) the net cash investment outstanding in respect of finance lease.

The method used should be applied consistently for similar types of leases.

(3) Manufacturer or dealer Lessors should include selling profit or loss in income accordance with the policy normally followed by the enterprise for outright sales.

(ii) Operating Leases

(1) Assets held for operating leases should be recorded as property, plant and equipment.

(2) Rental income should be recognised on a straight line basis unless another systematic basis is more representative of the time pattern of the earning. process.

(3) Depreciation Policy should be on a basis consistent with that for similar assets of the Lessor.

DISCLOSURE-ACCOUNTS OF LESSEES

(1) Amount of assets that are subject of finance leases at each balance sheet date.

(2) Liabilities to be disclosed separately from other liabilities and to distinguish current and non-current.

(3) Commitments for minimum lease payments under finance leases and under non-cancellable operating leases with a term of more than one year must be disclosed in summary form and be given with the amounts and periods in which payments will become due.

(4) Significant financing restrictions, renewal or purchase options, contingent rentals and other contingencies.

DISCLOSURE-ACCOUNTS OF LESSORS

(1) Gross investment in leases reported as finance leases and related unearned finance income and unguaranteed residual value of leased assets.

(2) Basis for allocating income so as to produce a constant periodic rate of return, indicating whether the return relates to the net investment outstanding or the net cash investment outstanding in lease.

(3) If a significant part of Lessor's business comprises operating leases, the Lessor should disclose the amount of assets by each major class of asset together with related accumulated depreciation.