Accounting standards

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Accounting Standards (ASs) are

- written policy documents issued by expert accounting body or by government or other regulatory body

- covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements.

- The Accounting Standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

AS 4 - contingencies applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government.

For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard.

Thus, the present standard (AS 4 (Revised)) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Contingencies

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Accounting Treatment of Contingent Losses

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

Example: ABC has filed case against a debtor against a recovery of Rs. 25 Lakhs. According to the legal team, the chances of recovery is nil. Therefore, ABC should make provisions for doubtful debt.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Events Occurring after the Balance Sheet Date

Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors

For example, for the year ending on 31st March 2020, financial statement is finalised and approved by the Board of the directors of the company in its meeting held on 04th September 2020. In this case the events taking place between 01st April 2020 to 04th September 2020 are termed as events occurring after the balance sheet date.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Two types of events can be identified

Adjusting

Non Adjusting

Adjusting events- **those which provide further evidence of conditions that existed at the balance sheet date. For example a trade receivable declared insolvent after reporting date and state unable to pay full amount against whom provision for doubtful debt was created.**

Non-adjusting events- **those which are indicative of conditions that arose subsequent to the balance sheet date. For example, plant got damaged due to occurrence of fire.**

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Events Occurring after the Balance Sheet Date

Dividend declared after balance sheet date

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Events Occurring after the Balance Sheet Date

Going concern

Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements. In case the going concern assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a liquidation basis.

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AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Events Occurring after the Balance Sheet Date

Disclosure

Disclosure of events occurring after the balance sheet date requires the following information should be provided:

(a) The nature of the event;

(b) An estimate of the financial effect, or a statement that such an estimate cannot be made.

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Examples

Illustration 1

- *In X Co. Ltd., theft of cash of ` 5 lakhs by the cashier in January, 2020 was detected only in May, 2020. The accounts of the company were not yet approved by the Board of Directors of the company.*
- *Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2020. Decide.*

Examples

- Illustration 2
- An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.2020. The accounting year of the company ended on 31.3.2020. The accounts were approved on 30.6.2020. The loss from earthquake is estimated at ` 30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company

Examples

- **Illustration 3**
- *A company has filed a legal suit against the debtor from whom ` 15 lakh is recoverable as on 31.3.2020. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 2020. Can the company provide for full amount of ` 15 lakhs as provision for doubtful debts? Discuss.*

Examples

- **Illustration 4**
- *In preparing the financial statements of R Ltd. for the year ended 31st March, 2020, you come across the following information. State with reasons, how you would deal with this in the financial statements:*
- *The company invested 100 lakhs in April, 2020 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.*

Examples

- **Illustration 6**
- *While preparing its final accounts for the year ended 31st March, 2020 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 2020 a trade receivable for ` 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2020 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 2020?*

AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- The objective of AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises.

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AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- **Net Profit or Loss for the Period**
  - (a) Profit or loss from ordinary activities
  - (b) Extraordinary items
  - (c) Exceptional items

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AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- **PRIOR PERIOD ITEMS**

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

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AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- CHANGES IN ACCOUNTING ESTIMATES

An estimate may have to be revised if changes occur in the circumstances based on which the estimate was made, or as a result of new information, more experience or subsequent developments

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AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- **CHANGES IN ACCOUNTING POLICIES**

Accounting Policies can be changed only:

- when the adoption of a different accounting policy is required by statute; or
- for compliance with an Accounting Standard; or
- when it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change

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Illustration 1

- *Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ` 5.30 lakhs for the period October, 2008 to September, 2015 has been received and paid in February, 2016. However, the same was accounted in the year 2016-17. Comment on the accounting treatment done in the said case.*

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Illustration 2

(i) During the year 2016-2020, a medium size manufacturing company wrote down its inventories to net realisable value by ` 5,00,000. Is a separate disclosure necessary?

(ii) A company signed an agreement with the Employees Union on 1.9.2016 for revision of wages with retrospective effect from 30.9.2015. This would cost the company an additional liability of ` 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2016-17?

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Illustration 3

The company finds that the inventory sheets of 31.3.2016 did not include two pages containing details of inventory worth ` 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2020.

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Illustration 4

Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of ` 20,000 per month. Earlier there was no such scheme of pension in the organisation.

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AS 9 Revenue Recognition

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

AS 9 deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- *the sale of goods*
- *the rendering of services*
- *the use by others of enterprise resources yielding interest, royalties and dividends*

AS 9 Revenue Recognition

AS 9 does not deal with the following aspects of revenue recognition to which special considerations apply:

i. Revenue arising from construction contracts;

ii. Revenue arising from hire-purchase, lease agreements;

iii. Revenue arising from government grants and other similar subsidies;

iv. Revenue of insurance companies arising from insurance contracts.

Sale of Goods

Revenue from sales transactions should be recognised when the requirements as to performance are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection.

In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- the seller of goods has transferred to the buyer the property in the goods for a price
- all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

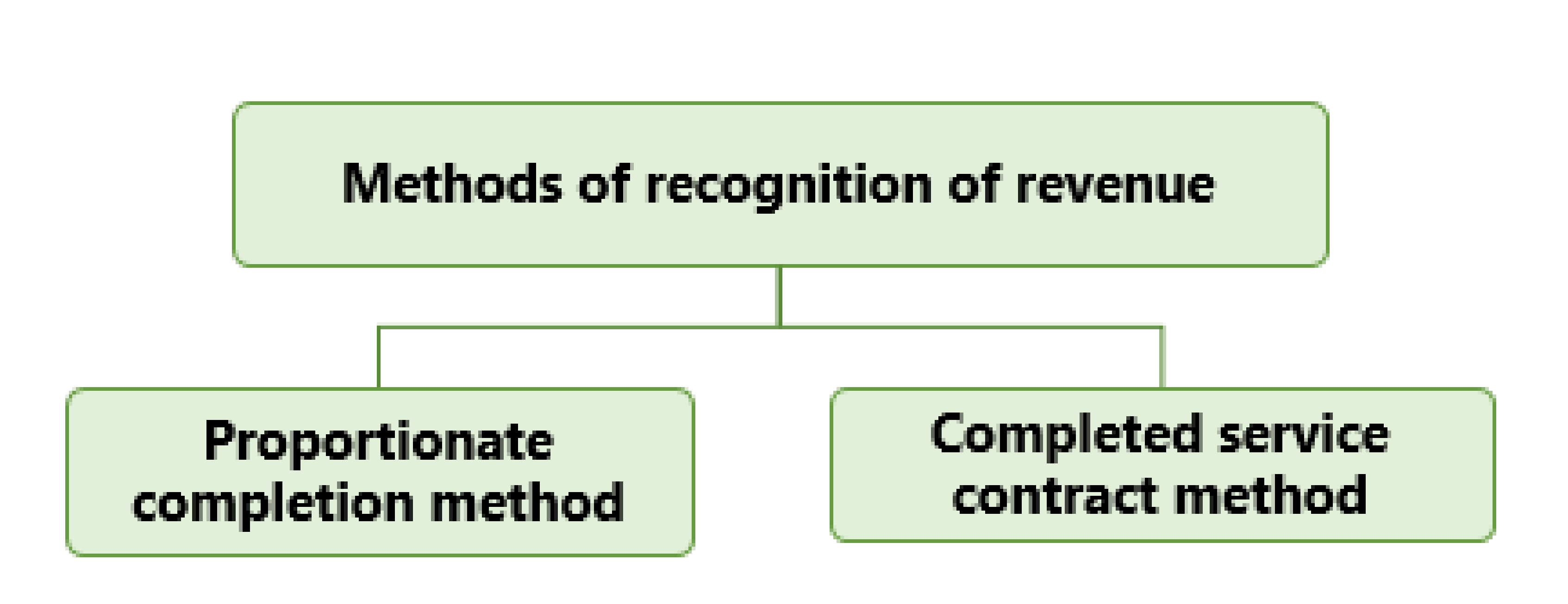
Sale of Goods

Risk and rewards:

- *Subject to installation and inspection*
- *Right to sales return*
- *Consignment sales*
- *Principal Vs Agent*
- *Sale and repurchase agreements*

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed.



Rendering of Services

Repair and installation service

Payroll service

Telecom service

Income from other sources – Interest, Royalties and Dividends

i.Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognised on a time proportion basis taking into account the amount outstanding and the rate applicable.

ii.Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognised on an accrual basis in accordance with the terms of the relevant agreement.

iii. Dividends: rewards from the holding of investments in shares. Revenue is recognised when the owner's right to receive payment is established.

Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved.

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

Illustration1

The Board of Directors decided on 31.3.2020 to increase the sale price of certain items retrospectively from 1st January, 2020. In view of this price revision with effect from 1st January 2020, the company has to receive ` 15 lakhs from its customers in respect of sales made from 1st January, 2020 to 31st March, 2020. Accountant cannot make up his mind whether to include ` 15 lakhs in the sales for 2020.Advise.

Illustration 2

Y Ltd., used certain resources of X Ltd. In return X Ltd. received ` 10 lakhs and ` 15 lakhs as interest and royalties respective from Y Ltd. during the year 2016-17. You are required to state whether and on what basis these revenues can be recognised by X Ltd.

Illustration 4

On 31st March, XYZ supplied goods on Consignment basis to ABC – a retail outlet worth Rs. 10,00,000. As per the terms, ABC will only pay XYZ for the goods which are sold by them to the third party. Rest of the goods can be returned back to XYZ and ABC will not have any further liability for these goods.

During the period 2018-19 ABC has sold goods worth Rs. 5,50,000 only and rest of the goods are still lying in its store which may get sold by next year. Advise XYZ, how much revenue it can recognise in its books for period 2018-19

AS 7 Construction contract

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use

A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel.

Or

A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

AS 7 Construction contract

Types of construction contracts

Fixed price contract

the price is agreed as fixed sum or a fixed rate per unit of output. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

Cost plus contract

is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

Percentage Completion Method

- Construction contracts are mostly long term, i.e. they take more than one accounting year to complete.
- This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over.

- Recognize revenue and profit annually in proportion of progress of work

- If contract results in loss:

the loss should be recognised as an expense immediately.

Stage of Completion

- the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- surveys of work performed; or
- completion of a physical proportion of the contract work.

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Conditions for fixed price contracts

- total contract revenue can be measured reliably;
- it is probable that the economic benefits associated with the contract will flow to the enterprise;
- both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

Conditions for cost plus contract

- it is probable that the economic benefits associated with the contract will flow to the enterprise; and
- the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/13. The fixed contract price agreed was ` 2,00,000. The company incurred ` 81,000 in 2013-14 for 45% work and received ` 79,000 as progress payment from the customer. The cost incurred in 2014-15 was ` 89,000 to complete the rest of work.

Example 3

	` 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

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Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts.

The standard identifies certain cases where for the purposes of accounting, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

Single

- the group of contracts is negotiated as a single package;
- the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- the contracts are performed concurrently or in a continuous sequence.

Separate

- separate proposals have been submitted for each asset;
- each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- the costs and revenues of each asset can be identified.

Combining and Segmenting Construction Contracts

A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(ii) the price of the asset is negotiated without regard to the original contract

Example 4

XYZ construction Ltd, a construction company undertakes the construction of an industrial complex. It has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should XYZ Ltd, treat construction of each unit as a separate construction contract according to AS 7?

Contract Revenue and Costs

Contract revenue

- the initial amount of revenue agreed in the contract; and
- variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

Contract costs

- costs that relate directly to the specific contract;
- costs that are attributable to contract activity in general and can be allocated to the contract; and
- such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs

<u>Examples of costs that relate directly to a specific contract include:</u>

(a) site labour costs, including site supervision
(b) costs of materials used in construction
(c) depreciation of plant and equipment used on the contract
(d) costs of moving plant, equipment and materials to and from the contract site
(e) costs of hiring plant and equipment
(f) costs of design and technical assistance that is directly related to the contract
(g) the estimated costs of rectification and guarantee work, including expected warranty costs
(h) claims from third parties

<u>Example of costs that may be attributable to contract activity in general and can be allocated to specific contracts include:</u>

(a) insurance
(b) costs of design and technical assistance that is not directly related to a specific contract
(c) construction overheads

Costs

Examples of costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract

(b) selling costs

(c) research and development costs for which reimbursement is not specified in the contract

(d) depreciation of idle plant and equipment that is not used on a particular contract

Disclosures

(a) An enterprise should disclose:

- (i) the amount of contract revenue recognised as revenue in the period;
- (ii) the methods used to determine the contract revenue recognised in the period; and
- (iii) the methods used to determine the stage of completion of contracts in progress.

(b) An enterprise should disclose following in respect of contracts in progress at the reporting date:

- (i) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
- (ii) the amount of advances received; and
- (iii) the amount of retentions.

  Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

  Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer.

  Advances are amounts received by the contractor before the related work is performed.

Disclosures

(c) An enterprise should present:

(i) the gross amount due from customers for contract work as an asset; and

(ii) the gross amount due to customers for contract work as a liability.

Particulars	`
Costs incurred	xxx
Plus: Recognised profits	xxx
Less: Recognised losses	xxx
Less: Progress billings	xxx
Amount	xxx
If above amount is **positive**- Gross amount due **from** customers	
If above amount is **negative**- Gross amount due **from** customers	

Illustrations

Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2020.

	(` in lakhs)
Total Contract Price	*1,000*
Work Certified for the cost incurred	*500*
Work yet not Certified for the cost incurred	*105*
Estimated further Cost to Completion	*495*
Progress Payment Received	*400*
To be Received	*140*

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7.

Illustrations

Illustration

On 1st December, 2016, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ` 85 lakhs. On 31st March, 2020, the company found that it had already spent ` 64,99,000 on the construction. Prudent estimate of additional cost for completion was ` 32,01,000. What amount should be charged to recognized in the statement of profit and loss for the year ended 31st March, 2020 as per provisions of Accounting Standard 7 ?

AS 19 Leases

A Lease is an agreement whereby the Lessor (legal owner of an asset) conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time.

Applicability AS 19 Leases

The standard applies to all leases other than:

(a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

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

(c) lease agreements to use lands

AS 19 Leases

Types of Leases

Finance leases

Operating Lease

A lease classified as *Finance Lease* **if it transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred**

A lease is classified as an *Operating Lease* if it does not transfer substantially all the risk and rewards incident to ownership.

Indicators of Finance Lease

Primary Indicators :

1. The lease transfers ownership of the asset to the lessee by the end of the lease term;
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
3. The lease term is for the major part of the economic life of the asset even if title is not transferred;
4. At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
5. The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Additional Indicators :

1. If the lessee can cancel the lease and the lessor’s losses associated with the cancellation are borne by the lessee;
2. 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); and
3. If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Accounting for Finance Leases (Books of lessee)

On the date of inception of Lease,

- Asset and corresponding liability at lower of:
  - Fair value of leased asset at the inception of the lease
  - Present value of minimum lease payments from the standpoint of the lessee

- Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

- Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

- Depreciation for asset

- Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Accounting for Finance Leases (Books of lessee)

Example 2

Annual lease rents = ` 50,000 at the end of each year.

Lease period = 5 years;

Guaranteed residual value = ` 25,000

Unguaranteed residual value (UGR)= ` 15,000

Fair Value at the inception (beginning) of lease = ` 2,00,000

Interest rate implicit on lease is =12.6%

Accounting for Finance Leases (Books of lessee)

Illustration 1

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 1^{st} year, 2^{nd} year, 3^{rd} year and 4^{th} year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.
Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1

Accounting for Finance Leases (Books of lessor)

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.

In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

Gross investment in Lease (GIL)
= Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGR)

Net investment in Lease (NIL)
= Gross investment in Lease (GIL) – Unearned Finance Income (UFI).
Unearned finance income (UFI) = GIL – (PV of MLP + PV of UGR)

Accounting for Finance Leases (Books of lessor)

Initial Direct Costs

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

Accounting for Finance Leases (Books of lessor)

Illustration 2

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

		(` In lakhs)
(i)	*Fair value of the machine*	*48.00*
(ii)	*Lease term*	*5 years*
(iii)	*Lease rental per annum*	*8.00*
(iv)	*Guaranteed residual value*	*1.60*
(v)	*Expected residual value*	*3.00*
(vi)	*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.

Accounting for Finance Leases (Books of lessor)

Manufacturer or dealer lessor

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Accounting for Operating Leases(Books of lessee)

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee 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.

Example – ABC has taken a shop on lease for 3 years in a mall in Delhi NCR. Considering low footfall initially, lessor has set yearly rental as Year 1, Year 2 and Year 3 Rs.10000, Rs 12000 and Rs. 14000 respectively.

Example - Suppose outputs from a machine taken on a 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. The total lease payment ` 1,20,000 in this example should be recognised in proportion of output as ` 15,000 in year 1, ` 30,000 in year 2 and ` 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalisation A/c.

Accounting for Operating Leases(Books of Lessor)

(i) The lessor should present an asset given under operating lease as fixed assets in its balance sheets.

(ii) 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.

(iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.

(iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28.

Sale and Leaseback

Where sale and leaseback results in finance lease

The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in <u>proportion to the depreciation</u> of the leased asset.

For example
ABC has a property in it books at Rs. 15,00,000 and remaining economic life was 20 years. ABC sold this property to a bank for Rs. 18,00,000 where as FV and taken the same back on lease for 19 years.
As per AS 19 guidance, this leaseback classifies as finance lease. So Rs. 3,00,000 difference of profit made by ABC will not be transferred to profit and loss account straight away. This will be parked in balance sheet and amortized over the lease period of 19 years

Sale and Leaseback

Illustration 3

A Ltd. sold machinery having WDV of ` 40 lakhs to B Ltd. for ` 50 lakhs and 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.

Thank You

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