

EXPOSURE DRAFT

Accounting Standard for Local Bodies (ASLB) 13 Leases (Based on corresponding IPSAS 13)

(Last date of comments: October 30, 2019)



Issued by
The Committee on Public and Government Financial Management
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Exposure Draft
Accounting Standard for Local Bodies (ASLB) 13 — Leases

CONTENTS

	Paragraphs
Objective	1
Scope	2-7
Definitions	8-11
Changes in Lease Payments between the Inception of the Lease and the Commencement of the Lease Term	9
Hire Purchase Contracts	10
Incremental Borrowing Rate of Interest	11
Classification of Leases	12-24
Leases and other Contracts	25-27
Leases in the Financial Statements of Lessees.....	28-44
Finance Leases	28-41
Operating Leases	42-44
Leases in the Financial Statements of Lessors.....	45-69
Finance Leases	45-61
Initial Recognition	50-61
Operating Leases	62-69
Sale and Leaseback Transactions	70-78
Appendix 1 Comparison with IPSAS 13, 'Leases'	
Appendix 2 Comparison with existing AS 19, 'Leases'	

Exposure Draft
Accounting Standard for Local Bodies (ASLB) 13
Leases

Invitation to Comment

The Committee on Public and Government Financial Management of the Institute of Chartered Accountants of India invites comments on any aspect of this Exposure Draft of the Accounting Standard for Local Bodies (ASLB) 13, 'Leases'. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Committee on Public and Government Financial Management, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than October 30, 2019. Comments can also be sent by e-mail at caslb@icai.in and cpf.aslb@icai.in

Question:

1. Paragraph 2 of draft ASLB 13 prescribes the following:

The criteria of classification of leases as prescribed in the standard is not to be applied to the leases of the Land and Buildings. All leases of land and buildings are to be treated as operating leases for the purpose of accounting as per this Standard.

Do you agree that the above provision is appropriate in the context of Local Bodies in India? Please provide rationale for your views.

Exposure Draft

Accounting Standard for Local Bodies (ASLB) 13

Leases

(This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority, Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies¹.)

The Accounting standard for local bodies ASLB 13, 'Leases' issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the local bodies. This Standard will be mandatory for local bodies in a State from the date specified in this regard by the State Government concerned².

The following is the text of the Accounting Standard for Local Bodies (ASLB) 13, 'Leases':

Objective

1. The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

Scope

2. ***An entity that prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for all leases other than:***
 - (a) ***Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and***
 - (b) ***Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.***

However, this Standard should not be applied as the basis of measurement for:

- (a) ***Property held by Lessees that is accounted for as investment property (see ASLB 16, 'Investment Property'³);***
- (b) ***Investment property provided by lessors under operating leases (see ASLB 16, 'Investment Property');***
- (c) ***Biological assets held by lessees under finance leases; or***
- (d) ***Biological assets provided by lessors under operating leases.***

The criteria of classification of leases as prescribed in the standard is not to be applied to the leases of the Land and Buildings. All leases of land and buildings are to be treated as operating leases for the purpose of accounting as per this Standard.

3. ***This Standard applies to all the entities described as local bodies in the 'Preface to Accounting Standards for Local Bodies'⁴.***

¹ Attention is specifically drawn to paragraph 4.2 of the 'Preface to the Accounting Standards for Local Bodies', according to which Accounting Standards are intended to apply only to items which are material.

² Reference may be made to the paragraph 7.1 of the 'Preface to the Accounting Standards for Local Bodies' providing the discussion on the compliance with the Accounting Standards for Local Bodies.

³ This ASLB is under formulation.

4. [Deleted]
5. This Standard applies to agreements that transfer the right to use assets, even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. Local Bodies may enter into complex arrangements for the delivery of services, which may or may not include leases of assets. These arrangements are discussed in paragraphs 25 to 27.
6. This Standard does not apply to (a) lease agreements to explore for or use natural resources such as oil, gas, timber, metals, and other mineral rights, and (b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This is because these types of agreements have the potential to raise complex accounting issues that need to be addressed separately.
7. [Refer to Appendix 1]

Definitions

8. *The following terms are used in this Standard with the meanings specified:*

The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e., the recognition of the assets, liabilities, revenue, or expenses resulting from the lease, as appropriate).

Contingent rent is that portion of the lease payments that is not fixed in amount, but is based on the future amount of a factor that changes other than the passage of time (e.g., percentage of future sales, amount of future use, future price indices, future market rates of interest).

Economic life is either:

- (a) The period over which an asset is expected to yield economic benefits or service potential to one or more users; or***
- (b) The number of production or similar units expected to be obtained from the asset by one or more users.***

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Gross investment in the lease is the aggregate of:

- (a) The minimum lease payments receivable by the lessor under a finance lease; and***
- (b) Any unguaranteed residual value accruing to the lessor.***

Guaranteed residual value is:

- (a) For a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and***

⁴ Refer paragraph 1.3 of the 'Preface to the Accounting Standards for Local Bodies'.

- (b) *For a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.*

The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

- (a) *A lease is classified as either an operating or a finance lease; and*
(b) *In the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.*

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or trader lessors⁵.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

- (a) *The minimum lease payments; and*
(b) *The unguaranteed residual value*

to be equal to the sum of (i) the fair value of the leased asset, and (ii) any initial direct costs of the lessor.

A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time.

The lease term is the non-cancelable period for which the lessee has contracted to lease the asset, together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

The lessee's incremental borrowing rate of interest 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.

Minimum lease payments are the payments over the lease term that the lessee is, or can be, required to make, excluding contingent rent, costs for services and, where appropriate, taxes to be paid by and reimbursed to the lessor, together with:

- (a) *For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or*
(b) *For a lessor, any residual value guaranteed to the lessor by:*
(i) *The lessee;*
(ii) *A party related to the lessee; or*
(iii) *An independent third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.*

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

⁵ The concept of manufacturer or trader lessor may not be relevant for Local Bodies in current scenario. However, the same may be relevant in future, hence retained here.

A non-cancelable lease is a lease that is cancelable only:

- (a) Upon the occurrence of some remote contingency;***
- (b) With the permission of the lessor;***
- (c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or***
- (d) Upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.***

An operating lease is a lease other than a finance lease.

Unearned finance revenue is the difference between:

- (a) The gross investment in the lease; and***
- (b) The net investment in the lease.***

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits or service potential embodied in the asset are expected to be consumed by the entity.

Terms defined in other Accounting Standards for Local Bodies (ASLBs) are used in this Standard with the same meaning as in those other Standards.

Changes in Lease Payments between the Inception of the Lease and the Commencement of the Lease Term

9. A lease agreement or commitment may include a provision to adjust the lease payments (a) for changes in the construction or acquisition cost of the leased property, or (b) for changes in some other measure of cost or value, such as general price levels, or in the lessor's costs of financing the lease, during the period between the inception of the lease and the commencement of the lease term. If so, the effect of any such changes should be deemed to have taken place at the inception of the lease for the purposes of this Standard.

Hire Purchase Contracts

10. The definition of a lease includes contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

Incremental Borrowing Rate of Interest

11. Where an entity has borrowings that are guaranteed by the government, the determination of the lessee's incremental borrowing rate of interest reflects the existence of any government guarantee and any related fees. This will normally lead to the use of a lower incremental borrowing rate of interest.

Classification of Leases⁶

12. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of (a) losses from idle capacity, technological obsolescence, or (b) changes in value because of changing economic conditions. Rewards may be represented by the expectation of service potential or profitable operation over the asset's economic life, and of gain from appreciation in value or realisation of a residual value.
13. ***A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.***
14. Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.
15. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Although the following are examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease, a lease does not need to meet all these criteria in order to be classified as a finance lease:
 - (a) The lease transfers ownership of the asset to the lessee by the end of the lease term;
 - (b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
 - (c) The lease term is for the major part of the economic life of the asset even if title is not transferred;
 - (d) 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;
 - (e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications; and
 - (f) The leased assets cannot easily be replaced by another asset.
16. Other indicators that individually or in combination could also lead to a lease being classified as a finance lease are:
 - (a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
 - (b) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and
 - (c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
17. The examples and indicators in paragraphs 15 and 16 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case (a) if ownership of the asset transfers at the end of the lease for a variable payment equal to its then

⁶ Not to be applied on the lease of Land and Building. All leases of land and building are to be treated as operating leases.

fair value, or (b) if there are contingent rents as a result of which the lessee does not have substantially all such risks and rewards.

18. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 12 - 17 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or the residual value of the leased property) or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

19-20. [Deleted]

20A-24. [Refer to Appendix 1]

Leases and Other Contracts

25. A contract may consist solely of an agreement to lease an asset. However, a lease may also be one element in a broader set of agreements with private sector entities to construct, own, operate, and/or transfer assets. Local Bodies often enter into such agreements, particularly in relation to long-lived physical assets and infrastructure assets. Other agreements may involve a local body leasing infrastructure from the private sector. The entity determines whether the arrangement is a service concession arrangement, as defined in ASLB 32, 'Service Concession Arrangements: Grantor'⁷.
26. Where an arrangement does not meet the conditions for recognition of a service concession asset in accordance with ASLB 32 and the arrangement contains an identifiable operating lease or finance lease as defined in this Standard, the provisions of this Standard are applied in accounting for the lease component of the arrangement.
27. Local Bodies may also enter a variety of agreements for the provision of goods and/or services, which necessarily involve the use of dedicated assets. In some of these agreements, it may not be clear whether a service concession arrangement as defined in ASLB 32 or a lease, as defined by this Standard, has arisen. In these cases, professional judgment is exercised, and if a lease has arisen this standard is applied; if a lease has not arisen, entities account for those agreements by applying the provisions of other relevant ASLBs⁸.

Leases in the Financial Statements of Lessees

Finance Leases

28. ***At the commencement of the lease term, lessees should recognise assets acquired under finance leases as assets, and the associated lease obligations as liabilities in their balance sheet. The assets and liabilities should be recognised at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.***

⁷ This ASLB is under formulation.

⁸ ASLB 32, 'Service Concession Arrangements: Grantor' is under formulation. Till the time the ASLB 32 is issued, guidance may be obtained from other corresponding pronouncements as per the hierarchy prescribed in paragraph 15 of the ASLB 3, 'Accounting Policies, Changes in Accounting Estimates, and Errors'.

29. Transactions and other events are accounted for and presented in accordance with their substance and financial reality, and not merely with legal form. Although the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating, at the inception of the lease, the fair value of the asset and the related finance charge.
30. If such lease transactions are not reflected in the lessee's financial statements, the assets and liabilities of an entity are understated, thereby distorting financial ratios. Therefore, it is appropriate for a finance lease to be recognised in the lessee's financial statements both as an asset and as an obligation to pay future lease payments. At the commencement of the lease term, the asset and the liability for the future lease payments are recognised in the financial statements at the same amounts, except for any initial direct costs of the lessee that are added to the amount recognised as an asset.
31. It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets.
32. If, for the presentation of liabilities on the face of the balance sheet, a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.
33. Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognised as an asset.
34. ***Minimum lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents should be charged as expenses in the period in which they are incurred.***
35. In practice, in allocating the finance charge to periods during the lease term, a lessee may use some form of approximation to simplify the calculation.
36. ***A finance lease gives rise to a depreciation expense for depreciable assets as well as a finance expense for each accounting period. The depreciation policy for depreciable leased assets should be consistent with that for depreciable assets that are owned, and the depreciation recognised should be calculated in accordance with ASLB 17, 'Property, Plant and Equipment', and ASLB 31, 'Intangible Assets', as appropriate. If there is no reasonable certainty that the 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.***
37. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term or its useful life.
38. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is therefore inappropriate simply to recognise the lease payments payable as an expense. Accordingly, the asset and the related liability are unlikely to be equal in amount after the commencement of the lease term.

39. To determine whether a leased asset has become impaired, an entity applies relevant impairment tests in accordance with ASLB 21, 'Impairment of Non-Cash generating Assets' and ASLB 26, 'Impairment of Cash-Generating Assets'⁹.
40. **Lessees should disclose the following for finance leases:**
- (a) **For each class of asset, the net carrying amount at the reporting date;**
 - (b) **A reconciliation between the total of future minimum lease payments at the reporting date, and their present value;**
 - (c) **In addition, an entity should disclose the total of future minimum lease payments at the reporting 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; and**
 - (iii) **Later than five years;**
 - (d) **Contingent rents recognised as an expense in the period;**
 - (e) **The total of future minimum sublease payments expected to be received under non-cancelable subleases at the reporting date; and**
 - (f) **A general description of the lessee's material leasing arrangements including, but not limited to, the following:**
 - (i) **The basis on which contingent rent payable is 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 return of net surplus, return of capital contributions, additional debt, and further leasing.**
41. In addition, the requirements for disclosure in accordance with ASLB 16, 'Investment Property', ASLB 17, 'Property, Plant and Equipment', ASLB 21, 'Impairment of Non-Cash generating Assets', ASLB 26, 'Impairment of Cash-Generating Assets', and ASLB 31, 'Intangible Assets' are applied to the amounts of leased assets under finance leases that are accounted for by the lessee as acquisitions of assets.

Operating Leases

42. **Lease payments under an operating lease should be recognised as an expense on a straight-line basis over the lease term, unless either:**
- (a) **another systematic basis is representative of the time pattern of the user's benefit even if the payments to the lessors are not on that basis; or**
 - (b) **the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition is not met.**
43. For operating leases, lease payments (including initial direct costs and excluding costs for services) are recognised as an expense on a straight-line basis, unless another systematic basis

⁹ The formulation of these ASLBs is under formulation.

is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

- 43A. Initial direct costs are often incurred by lessee in negotiating and securing operating leasing arrangements and are added to the lease payments. However, costs for services such as insurance and maintenance are excluded from lease payments.
44. ***Lessees should disclose the following 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; and***
 - (iii) ***Later than five years;***
 - (b) ***The total of future minimum sublease payments expected to be received under non-cancelable subleases at the reporting date;***
 - (c) ***Lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments; and***
 - (d) ***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 return of net surplus, return of capital contributions, additional debt, and further leasing.***

Leases in the Financial Statements of Lessors

Finance Leases

45. This Standard describes the treatment of finance revenue earned under finance leases. The term "manufacturer or trader lessor¹⁰" is used in this Standard to refer to all entities that manufacture or trade assets and also act as lessors of those assets, regardless of the scale of their leasing, trading, and manufacturing activities. With respect to an entity that is a manufacturer or trader lessor, the Standard also describes the treatment of gains or losses arising from the transfer of assets.
46. Local Bodies may enter into finance leases as a lessor under a variety of circumstances. Some local bodies may trade assets on a regular basis. For example, local bodies may create special purpose entities that are responsible for the central procurement of assets and supplies for all other entities. Centralisation of the purchasing function may provide greater opportunity to obtain trade discounts or other favorable conditions. In some cases, a central purchasing entity may purchase items on behalf of other entities, with all transactions being conducted in the name of

¹⁰ The concept of manufacturer or trader lessor may not be relevant for Local Bodies in current scenario. However, the same may be relevant in future, hence retained here.

the other entities. In other cases, a central purchasing entity may purchase items in its own name, and its functions may include:

- (a) Procuring assets and supplies;
- (b) Transferring assets by way of sale or finance lease; and/or
- (c) Managing a portfolio of assets, such as a motor vehicle fleet, for use by other entities, and making those assets available for short or long term lease, or purchase.

47. Other local bodies may enter into lease transactions on a more limited scale and at less frequent intervals. In particular, in some cases entities that have traditionally owned and operated infrastructure assets such as roads, dams, and water treatment plants are no longer automatically assuming complete ownership and operational responsibility for these assets. Local Bodies may transfer existing infrastructure assets to private sector entities by way of sale or by way of finance lease. In addition, local bodies may construct new long-lived physical and infrastructure assets in partnership with private sector entities, with the intention that the private sector entity will assume responsibility for the assets by way of outright purchase or by way of finance lease once they are completed. In some cases, the arrangement provides for a period of control by the private sector before reversion of title and control of the asset to the local body — for example, a local body may lease the facility of water treatment plant to a private sector company for a period of twenty years, after which time the facility reverts to public control.
48. ***Lessors should recognise lease payments receivable under a finance lease as assets in their balance sheet. They should present such assets as a receivable at an amount equal to the net investment in the lease.***
49. Under a finance lease, substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance revenue to reimburse and reward the lessor for its investment and services.

Initial Recognition

50. Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees, and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads, such as those incurred by a sales and marketing team. For finance leases other than those involving manufacturer or trader lessors, initial direct costs are included in the initial measurement of the finance lease receivable, and reduce the amount of revenue recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable; there is no need to add them separately. Costs incurred by manufacturer or trader lessors in connection with negotiating and arranging a lease, are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease, and are recognised as an expense when the gain or loss on sale is recognised, which for a finance lease is normally at the commencement of the lease term.
51. ***The recognition of finance revenue should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.***
52. A lessor aims to allocate finance revenue over the lease term on a systematic and rational basis. This revenue allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease. Lease payments relating to the accounting period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance revenue.
53. Estimated unguaranteed residual values used in computing the lessor's gross investment in a

lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the revenue allocation over the lease term is revised, and any reduction in respect of amounts already accrued is recognised immediately.

54. ***Manufacturer or trader lessors should recognise gains or losses on sale of assets in the period, in accordance with the policy followed by the entity for outright sales.***
55. ***If artificially low rates of interest are quoted, any gains or losses on sale of assets should be restricted to what would apply if a market rate of interest were charged. Costs incurred by manufacturer or trader lessors in connection with negotiating and arranging a lease should be recognised as an expense when the gain or loss is recognised.***
56. Local Bodies that manufacture or trade assets may offer to potential purchasers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or trader lessor gives rise to two types of revenue:
 - (a) The gain or loss equivalent to the gain or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and
 - (b) The finance revenue over the lease term.
57. The sales revenue recognised at the commencement of the lease term by a manufacturer or trader lessor is the fair value of the asset, or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a commercial rate of interest. The cost of sale of an asset recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased property, less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the gain or loss on sale which is recognised in accordance with the entity's policy for outright sales.
58. Manufacturer or trader lessors may sometimes offer customers lower rates of interest than their normal lending rates. The use of such a rate would result in an excessive portion of the total revenue from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, revenue recognised as gain or loss on sale is restricted to what would apply if the entity's normal lending rate for that type of transaction were charged.
59. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or trader's gain or loss on sale.
60. ***Lessors should disclose the following for finance leases:***
 - (a) ***A reconciliation between the total gross investment in the lease at the reporting date, and the present value of minimum lease payments receivable at the reporting date. In addition, an entity should disclose the gross investment in the lease and the present value of minimum lease payments receivable at the reporting date, for each of the following periods:***
 - (i) ***Not later than one year;***
 - (ii) ***Later than one year and not later than five years; and***
 - (iii) ***Later than five years;***
 - (b) ***Unearned finance revenue;***
 - (c) ***The unguaranteed residual values accruing to the benefit of the lessor;***

(d) The accumulated allowance for uncollectible minimum lease payments receivable;(e) Contingent rents recognised in the income and expenditure statement; and

(f) A general description of the lessor's material leasing arrangements.

61. As an indicator of growth in leasing activities it is often useful to also disclose the gross investment less unearned revenue in new business added during the accounting period, after deducting the relevant amounts for canceled leases.

Operating Leases

62. **Lessors should present assets subject to operating leases in their balance sheet according to the nature of the asset.**

63. **Lease revenue from operating leases should be recognised as revenue on a straight-line basis over the lease term, unless either:**

(a) another systematic basis is more representative of the time pattern in which benefits derived from the leased asset is diminished, even if the payments to the lessors are not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition is not met.

64. Costs, including depreciation, incurred in earning the lease revenue are recognised as an expense. Lease revenue (excluding receipts for services provided such as insurance and maintenance) is recognised as revenue on a straight line basis over the lease term, even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

65. **Initial direct costs incurred by lessors in negotiating and arranging an operating lease should be added to the carrying amount of the leased asset, and recognised as an expense over the lease term on the same basis as the lease revenue.**

66. **The depreciation policy for depreciable leased assets should be consistent with the lessor's normal depreciation policy for similar assets, and depreciation should be calculated in accordance with ASLB 17 or ASLB 31, as appropriate.**

67. To determine whether a leased asset has become impaired, an entity applies relevant impairment tests in accordance with ASLB 21, 'Impairment of Non-Cash generating Assets' and ASLB 26, 'Impairment of Cash-Generating Assets'.

68. A manufacturer or trader lessor does not recognise any gain on sale on entering into an operating lease because it is not the equivalent of a sale.

69. **Lessors should disclose the following for operating leases:**

(a) The future minimum lease payments under non-cancelable 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; and

(iii) Later than five years;

(b) *Total contingent rents recognised in the income and expenditure statement in the period; and*

(c) *A general description of the lessor's leasing arrangements.*

Sale and Leaseback Transactions¹¹

70. A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent, because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.
71. ***If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be immediately recognised as revenue by a seller-lessee. Instead, it should be deferred and amortised over the lease term.***
72. If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. For this reason, it is not appropriate to regard an excess of sales proceeds over the carrying amount as revenue. Such excess is deferred and amortised over the lease term.
73. ***If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any gain or loss should be recognised immediately. If the sale price is below fair value, any gain 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. 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.***
74. If the leaseback is an operating lease, and the lease payments and the sale price are at fair value, there has in effect been a normal sale transaction and any gain or loss is recognised immediately.
75. ***For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.***
76. For finance leases, no such adjustment is necessary unless (a) there has been an impairment in value, and (b) that impairment is required to be recognised in accordance with ASLB 21, 'Impairment of Non-Cash generating Assets' and ASLB 26, 'Impairment of Cash-Generating Assets' that has been adopted by the entity.
77. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.
78. Sale and leaseback transactions may be required to be separately disclosed in accordance with ASLB 1, 'Presentation of Financial Statements'.

79-80. [Deleted]

81-87. [Refer to Appendix 1]

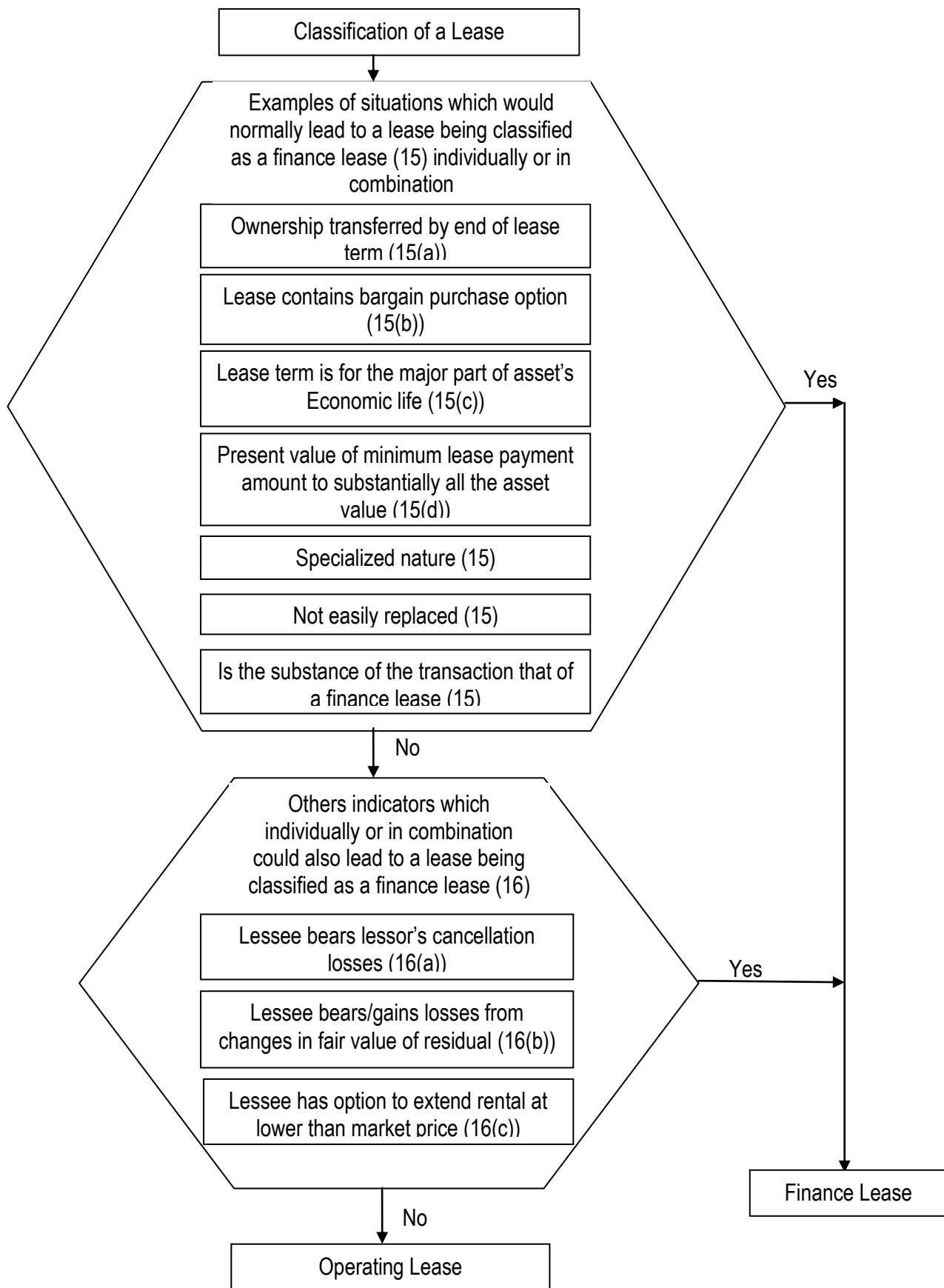
¹¹ Local Bodies in India may not undertake these type of transactions in current scenario. However, the same may be relevant in future, hence retained here.

Implementation Guidance

This guidance accompanies, but is not part of, ASLB 13.

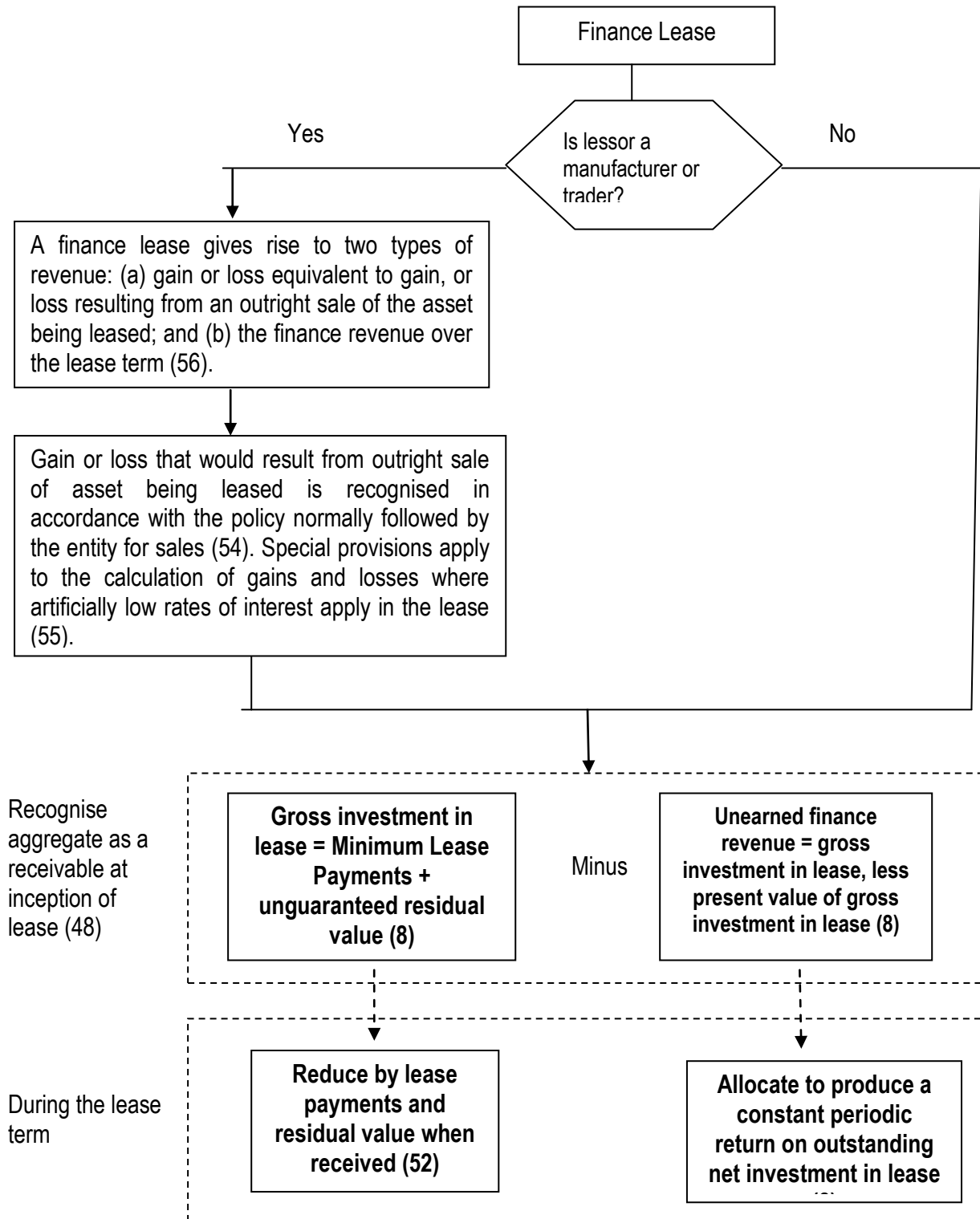
Classification of a Lease

- IG1. The objective of the chart on the next page is to assist in classifying a lease as either a finance lease or an operating lease. A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. An operating lease is a lease other than a finance lease.
- IG2. The examples contained in this chart do not necessarily reflect all possible situations in which a lease may be classified as a finance lease, nor should a lease necessarily be classified as a finance lease by virtue of the route followed in this chart. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract (paragraph 15).
- IG3. In the flowchart, the numbers in parentheses refer to paragraph numbers in this Standard.



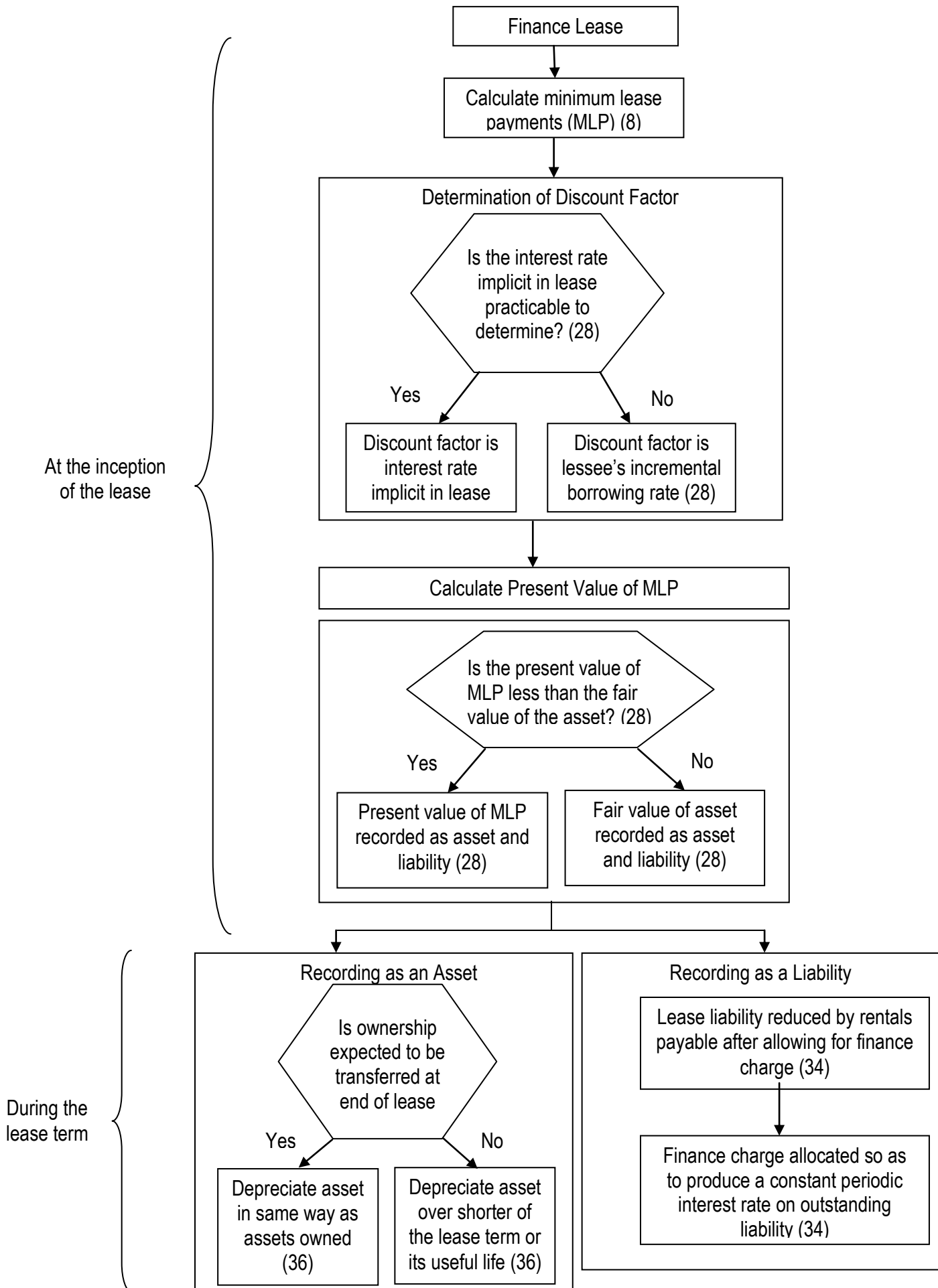
Accounting for a Finance Lease by a Lessor

IG4. In the flowchart, the numbers in parentheses refer to paragraph numbers in the Standard.



Accounting for a Finance Lease by a Lessee

IG5. In the flowchart, the numbers in parentheses refer to paragraph numbers in the Standard.



Sale and Leaseback Transactions that Result in Operating Leases

A sale and leaseback transaction that results in an operating lease may give rise to a gain or a loss, the determination and treatment of which depends upon the leased asset's carrying amount, fair value, and selling price. The table on the following page shows the requirements of this Standard in various circumstances.

Sale price established at fair value (paragraph 65)	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Gain	no gain	recognise gain immediately	no gain
Loss	no loss	no loss	recognise loss immediately

Sale price below fair value (paragraph 65)	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Gain	no gain	recognise gain immediately	no gain (note 1)
Loss <u>not</u> compensated by future lease payments at below market price	recognise loss immediately	recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	defer and amortise loss	defer and amortise loss	(note 1)

Sale price above fair value (paragraph 65)	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Gain	defer and amortise gain	defer and amortise gain (note 2)	defer and amortise gain (note 3)
Loss	no loss	no loss	(note 1)

Note 1 These parts of the table represent circumstances that would have been dealt with under paragraph 75 of this Standard. Paragraph 75 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 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 (paragraph 73).

Note 3 The gain would be the difference between fair value and sale price, as the carrying amount would have been written down to fair value in accordance with paragraph 75.

Calculating the Interest Rate Implicit in a Finance Lease

IG7. The Standard (paragraph 28) requires the lessees of assets acquired under finance leases to calculate the interest rate implicit in a lease, where practical. Paragraph 34 requires the lessees to apportion lease payments between the finance charge and the reduction of the outstanding liability, using the interest rate implicit in the lease. Many lease agreements explicitly identify the interest rate implicit in the lease, but some do not. If a lease agreement does not identify the interest rate implicit in the lease the lessee needs to calculate the rate, using the present value formula. Financial calculators and spreadsheets will automatically calculate the interest rate implicit in a lease. Where these are not available, entities can use the present value formula to manually calculate the rate. This guidance illustrates the following two common methods for calculating the interest rate: trial and error, and interpolation. Both methods use the present value formula to derive the interest rate.

IG8. Derivations of present value formulas are widely available in accounting and finance textbooks. The present value (PV) of minimum lease payments (MLP) is calculated by means of the following formula:

$$PV(MLP) = \frac{S}{(1+r)^n} + \frac{A}{r} \left[1 - \frac{1}{(1+r)^n} \right]$$

Where:

“S” is the guaranteed residual value

“A” is the regular periodical payment

“r” is the periodic interest rate implicit in the lease expressed as a decimal

“n” is the number of periods in the term of the lease

Example

IG8. Department X enters into an agreement to acquire a motor vehicle on a finance lease. The fair value of the motor vehicle at the inception of the lease is Rs. 25,000; the annual lease payments are Rs. 5,429 payable in arrears; the lease term is four years; and the guaranteed residual value is Rs. 10,000. The lease agreement does not provide for any services additional to the supply of the motor vehicle. Department X is responsible for all the running costs of the vehicle, including insurance, fuel, and maintenance. The lease agreement does not specify the interest rate implicit in the lease. The Department’s incremental borrowing rate is 7% per annum. Several financial institutions are advertising loans secured by motor vehicles at rates varying between 7.5% and 10%.

Trial and Error Method

IG9. The calculation is an iterative process – that is, the lessee must make a “best guess” of the interest rate and calculate the present value of the minimum lease payments and compare the result to the fair value of the leased asset at the inception of the lease. If the result is less than the fair value, the interest rate selected was too high; if the result is greater than the fair value, the interest rate selected was too low. The interest rate implicit in a lease is the rate used when the present value of the minimum lease payments is equal to the fair value of the leased asset at the inception of the lease.

IG10. Department X would begin calculations using a best estimate – for example its incremental borrowing rate of 7% per annum, which is too low. It would then use the maximum feasible rate – for example the 10% per annum rate offered for loans secured by a motor vehicle, which would prove too high. After several calculations, it would arrive at the correct rate of 8.5% per annum.

IG11. To calculate the interest rate, the Department uses the PV(MLP) formula above, where:

$$S = 10,000 \quad n = 4 \quad r = \text{Annual interest rate expressed as a decimal}$$

$$A = 5,429 \quad \text{Target PV(MLP)} = 25,000$$

IG12. At Department X's incremental borrowing rate of 7% (0.07) per annum (figures are rounded):

$$\begin{aligned} \text{PV(MLP)} &= \frac{10,000}{(1 + 0.07)^4} + \frac{5,429}{0.07} \left[1 - \frac{1}{(1 + 0.07)^4} \right] \\ &= 7,629 + 18,390 \\ &= 26,019 \end{aligned}$$

IG13. The PV(MLP) using the incremental borrowing rate is greater than the fair value of the leased asset, therefore a higher rate is implicit in the lease. The Department must make calculations at other rates to determine the actual rate (figures are rounded):

PV(MLP) at 7.5%	= 25,673	Interest rate too low
PV(MLP) at 10%	= 24,040	Interest rate too high
PV(MLP) at 9%	= 24,674	Interest rate too high
PV(MLP) at 8%	= 25,333	Interest rate too low
PV(MLP) at 8.5%	= 25,000	Correct interest rate

IG14. The Department will now use the interest rate of 8.5% to apportion the lease payments between the finance charge and the reduction of the lease liability, as shown in the table below.

Interpolation Method

IG15. Calculating the interest rate implicit in a lease requires lessees to initially calculate the present value for an interest rate that is too high, and one that is too low. The differences (in absolute terms) between the results obtained and the actual net present value are used to interpolate the correct interest rate. Using the data provided above, and the results for 7% and 10%, the actual rate can be interpolated as follows (figures are rounded):

$$\text{PV at 7\%} = 26,019, \text{ difference} = 1,019 \text{ (i.e., } 26,019 - 25,000\text{)}$$

$$\text{PV at 10\%} = 24,040, \text{ difference} = 960 \text{ (i.e., } 24,040 - 25,000\text{)}$$

$$\begin{aligned} r &= \frac{7\% + (10\% - 7\%) \cdot 1,019}{(1,019 + 960)} \\ &= 7\% + (3\% \times 0.5) \\ &= 7\% + 1.5\% \\ &= 8.5\% \end{aligned}$$

IG16. Department X will now use the interest rate of 8.5% to record the lease in its books and apportion the lease payments between the finance charge and the reduction of the lease liability, as shown in the table below.

Apportionment of Lease Payment (figures are rounded)

	Year 0	Year 1	Year 2	Year 3	Year 4
Opening PV of Lease Liability	25,000	25,000	21,69	18,11	14,221
Interest Expense	–	2,125	1,844	1,539	1,209

Reduction of Liability	–	3,304	3,585	3,890	14,221*
Closing Lease Liability	25,000	21,696	18,110	14,221	–

* Includes payment of guaranteed residual value.

Appendix 1

Note: This Appendix is not a part of the Accounting Standard for Local Bodies. The purpose of this Appendix is only to bring out the major differences, if any, between Accounting Standard for Local Bodies (ASLB) 13 and the corresponding International Public Sector Accounting Standard (IPSAS) 13, 'Leases'.

Comparison with IPSAS 13, 'Leases'

1. Different terminologies have been used in the draft ASLB 13 as compared to corresponding IPSAS 13, e.g., the terms 'balance sheet', 'entities' and 'income and expenditure statement' have been used in place of 'statement of financial position', 'public sector entities' and 'statement of financial performance'.
2. The following paragraphs of IPSAS 13 have been deleted. In order to maintain consistency with the corresponding IPSAS 13, the paragraph numbers have been retained:
 - i. Paragraph 7 of IPSAS 13 with regard to non-applicability of this Standard to investment property as the same was not found relevant.
 - ii. Paragraphs 20A-22 have been deleted as a consequence of the departure in the draft ASLB 13 pursuant to which all the leases of the land and buildings are to be treated as operating leases. The lease classification criteria given in the Standard is not be applied to the lease of the Buildings.
 - iii. Paragraph 23 of IPSAS 13 dealing with the measurement of land and buildings elements when the lessee's interest in both land and buildings is classified as an investment property in accordance with IPSAS 16, 'Investment Property' if the fair value model is adopted and paragraph 24 of IPSAS 17 dealing with property interest held under an operating lease as an investment property, if the definition of investment property is otherwise met and fair value model is applied, have been deleted, since draft ASLB 16, 'Investment Property' does not permit the use of fair value model.
 - iv. Paragraphs 80A-C pertaining to transitional provisions have been deleted as a separate ASLB corresponding to IPSAS 33, 'First-time adoption of Accrual basis IPSASs' will be issued that would cover all transitional provisions altogether instead of providing transitional provisions in separate ASLBs. Paragraphs 85-87 pertaining to effective date have been deleted as ASLBs would become mandatory for the Local Bodies in a State from the date specified by the State Government concerned.
3. Paragraph 3 of IPSAS 13 that earlier pertained to applicability of IPSASs has been deleted by the IPSASB from this Standard because a separate document of IPSASB on 'Applicability of IPSASs' now deals with the same. However, the provision pertaining to applicability of ASLBs has been covered in the Standard itself *in line with other* issued ASLBs.
4. The following paragraphs appear as 'Deleted' in IPSAS 13. In order to maintain consistency with paragraph number of IPSAS 13, this paragraph number has been retained in draft ASLB 13.
 - i. Paragraph 4
 - ii. Paragraph 19

- iii. Paragraph 20
- iv. Paragraph 79
- v. Paragraph 80.

5. The following paragraphs of IPSAS 13 have been amended significantly to make the same more relevant in the context of local bodies in India:

- i. Scope paragraph has been amended as the draft ASLB 13 proposes to consider all leases of buildings as operating leases. as a consequence para 20 A has also been amended.
- ii. Paragraph 8: The term 'fair value' has been defined additionally for more clarification.
- iii. Provisions pertaining to payment of dividends or similar distribution do not seem to be relevant in the context of Local Bodies. Therefore, the same have been deleted. (refer paragraphs 40(f)(iii) & 44(d)(iii))
- iv. Draft ASLB 13 requires that in case of operating lease, where escalation of lease rentals is in line with the expected general inflation so as to compensate the lessor for expected inflationary cost increases should not be straight lined. IPSAS 13 does not provide for the same. (paragraph 42 and 63)
- v. Paragraph 43A has been inserted to clarify that initial direct costs incurred by lessee in negotiating and security operating lease are to be added in lease payments. IPSAS 13 does not provide the same.
- vi. The following concepts may not be relevant for Local Bodies in Indian context. However, the same have been retained with appropriate footnotes for more clarification:
 - Manufacturer or trader lessor (paragraph 45), and
 - Sales and leaseback transactions (paragraphs 70-78).

6. Consequential changes resulting from the above departures have been made in the draft ASLB 13.

Appendix 2

Note: This Appendix is not a part of the Accounting Standard for Local Bodies. The purpose of this Appendix is only to bring out the major differences, if any, between Accounting Standard for Local Bodies (ASLB) 13 and the existing Accounting Standard (AS) 19, 'Leases' issued by the Institute of Chartered Accountants of India.

Comparison with Existing AS 19, 'Leases'

1. Different terminologies have been used in the draft ASLB 13 as compared to the existing AS 19, e.g., the terms 'income and expenditure statement' and 'trader lessor' have been used in place of 'profit and loss account' and 'dealer lessor'.
2. Draft ASLB 13 excludes property interest held by lessees accounted for as investment property or investment property provided by lessors under operating leases, from its scope, because the same will be dealt by ASLB 16, 'Investment Property'. However, the said exclusion is not there in existing AS 19.
3. As per the draft ASLB 13 all leases of land and buildings are to be treated as operating leases. However, the lease agreements to use lands are excluded from its scope from existing AS 9 and the lease of the buildings may be operating or finance as per the criteria prescribed in the existing AS 19.
4. Draft ASLB 13 prescribes that when an entity has borrowings that are guaranteed by the government than in that case the lessee's incremental borrowing rate of interest will be lower due to existence of any government guarantee and any related fees. However, existing AS 19 does not provide the same.
5. Existing AS 19 provides that in case of sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset. However, this concept is not relevant in Indian context but the same has been retained in the draft ASLB 13 with appropriate footnote for more clarification and it also provides that such excess as mentioned earlier is deferred and amortised over the lease term.
6. Existing AS 19 provides certain exemptions in respect of the disclosure requirements to a small and medium sized company/ enterprises. However, no such exemptions are provided to any local body in the draft ASLB 13.
7. Draft ASLB 13 requires that in case of operating lease, where escalation of lease rentals is in line with the expected general inflation so as to compensate the lessor for expected inflationary cost increases should not be straight lined. Existing AS 19 does not provide for the same.
8. Draft ASLB 13 also clarifies that initial direct costs incurred by lessee in negotiating and security operating lease are to be added in lease payments. Existing AS 19 does not provide for the same.
9. Appendices and Implementation Guidance in the draft ASLB 13 are more reflective of the circumstances of the Local Bodies.