Note

Depreciation Policy for lessor in case of Operating leases

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Note

PREAMBLE:

In case of operating leases, for accounting purpose, the leased asset is shown as a Fixed Asset in the books of Lessor and depreciation is claimed by the Lessor. The depreciation is charged either by Straight Line Method or Written down value method. The method of charging depreciation, disclosures to be made in the accounting statements, rate of depreciation etc. is governed by Accounting Standards issued by ICAI and governing statute being the Companies Act, 1956.

ACCOUNTING STANDARDS (AS):

AS 19 Leases:

As per paragraph 43 of AS 19, 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 6, Depreciation Accounting.

Further, as per paragraph 44 of AS 19, An enterprise can determine whether the leased asset has become impaired by applying AS 28 dealing with impairment of assets that sets out the requirement for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

As per paragraph 46, sub-paragraph (a), in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, and the governing Statute, needs to disclose for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
(i) the depreciation recognised in the statement of profit and loss for the period;
(ii) impairment losses recognised in the statement of profit and loss for the period;
(iii) impairment losses reversed in the statement of profit and loss for the period;

AS 6 Depreciation Accounting:

As per paragraph 11, the quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

As per paragraph 12, there are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business.

GOVERNING STATUTE - THE COMPANIES ACT, 1956

Section 205 of the Companies Act, 1956 (the "Act") prescribes the methods of charging depreciation. As per sub-section (2) of Section 205 of the Act, for the purpose of sub-section (1), depreciation shall be provided either -
(*a*) to the extent specified in section 350 ; or
(*b*) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent of the original cost thereof to the company by the specified period in respect of such asset ; or
(*c*) on any other basis approved by the Central Government which has the effect of writing off by the way of depreciation ninety-five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period ; or
(*d*) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case :
Provided that where depreciation is provided for in the manner laid down in clause (*b*) or clause (*c*), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

Further, Schedule XIV to the Act provides the rtes of depreciation to be charged whether under Straight line or Written down value method.

Note

CAN A LESSOR CHOOSE TO PROVIDE DEPRECIATION FOR THE LEASED ASSET AT A RATE HIGHER THAN THAT SPECIFIED UNDER THE STATUTE?

In order to evaluate the same; first we need to first analyze the downside of charging depreciation as per the governing statute:

Illustration A:

A Ltd. (Lessor) has leased an Asset to B Ltd. (Lessee) for a lease tenure of 3 years. The Cost of the Asset is Rs. 1000. The expected residual value as estimated by the Lessor at the end of lease tenure is 20%. The rate of depreciation for such Asset specified under Schedule XIV to the Companies Act, 1956 is 13.91%. If the Lessor continues to provide depreciation at the rate specified under the Act, at the end of lease tenure the position will be as under:

Carrying value of Asset in the Books of Account:

(figs. in Rs.)

Particulars	Year 1	Year 2	Year 3
Opening Balance	1000	860.9	741.15
Depreciation	139.1	119.75	103.09
Closing Balance	860.9	741.15	638.06

However, as per the Lessor the estimated residual value at the end of lease tenure will be Rs. 200. About 80% of the value of the Asset is expected to be depleted during the lease tenure.

Thus, the recoverable value of the asset is lesser than the carrying value of the asset. This will lead to an impairment loss[1] of Rs. 438.06. Impairment loss will be shown as an expense in the profit and loss account of the Lessor. Further, after the recognition of an impairment loss, the depreciation (amortisation) charge for the asset will be needed to be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value, on a systematic basis over its remaining useful life.

[1] As per AS 28 Impairment of Assets, impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Note

Impairment assessment is not a routine phenomenon adopted by a Company. Paragraphs 8 to 10 of AS 28 describes some indications that an impairment loss may have occurred: if any of those indications is present, an enterprise is required to make a formal estimate of recoverable amount. If no indication of a potential impairment loss is present, this Standard does not require an enterprise to make a formal estimate of recoverable amount. Thus assessment of impairment loss is subsequent to the enterprise getting an indication from either external or internal sources that there is a likelihood of impairment losses due to significant changes, obsolescence etc.

In the illustration mentioned above, the lessor, right at the inception of lease is certain that at the end of the lease tenure the value of the asset will be Rs. 200. In such a case it will not be prudent to provide depreciation as per general rate during the lease tenure, and then record an impairment loss at the end of the lease tenure.

In view of the above mentioned the Lessor can consider providing depreciation in the manner recommended below:

Recommended Depreciation:

$$\text{Depreciation} = \frac{\text{Cost of Asset} - \text{Expected Residual Value at the end of lease tenure}}{\text{Lease Tenure}}$$

Let us consider Illustration A and recalculate depreciation as recommended above, the following

$$\text{Depreciation} = \frac{1000-200}{3} = \text{Rs. } 266.67$$

Particulars	Year 1	Year 2	Year 3
Opening Balance	1000	733.33	466.66
Depreciation	266.67	266.67	266.67
Closing Balance	733.33	466.66	**200**

Note

The lessor makes a thorough assessment before arriving at the expected residual value. In such a case the depreciation provided needs to reflect the depletion in value and wear and tear of the leased asset.

IS THERE A PROVISION FOR THE SAME UNDER THE ACT?

The AS as well as the Act consists of such provisions under which the Lessor can charge depreciation at a rate higher than that provided therein by giving adequate disclosures in the books of accounts. Relevant extracts of the said provisions are reproduced hereunder:

AS 6 Depreciation Accounting:

13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. **Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate**. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

29. The following information should also be disclosed in the financial statements alongwith the disclosure of other accounting policies:
(i) depreciation methods used; and
(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

Schedule XIV Rates of Depreciation:

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5. The following information should also be disclosed in the accounts :

(i) depreciation methods used ; and
(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the Schedule.

Note

CONCLUSION

The rates provided under the Act are only indicative in nature. The rates specified as well as the general rate of depreciation of 13.91% provided therein for certain assets need not be an optimal rate. The Management needs to identify the rate at which the asset is to be depreciated in order to ensure that the actual depletion in value is clearly indicated and no impairment losses needs to be recorded for the same. The Act as well as the AS clearly provides for the same subject to the condition that disclosure requirements are duly complied with. Thus, the depreciation policy for Lessor in case of operating leases to a great extent depends on the judgement of the Management and not simply what is provided under the governing statute.

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