Accounting for Lease

Introduction:

Capital asset is one of the important assets of every business concern. Heavy funds are required to construct or purchase of any capital assets. To avoid such type of heavy investment, the other way is to use to get capital assets i.e. on lease.

Lease means a method of acquiring right to use an assets for a consideration. It enables to businessman to reduce his investment in the project by taking assets on hire rather than owning it. For this purpose the contract of lease is entered. It is defined as “contract where by the owner of an assets grants another party the exclusive right to use the assets usually for an agreed period of time in return for the payment of rent.” It means that a lease is a contractual agreement between owner and the user of the assets. Contract of lease provides an opportunity to use an asset which belongs to another person.

The real owner of the assets is called as lessor and the user of the assets is called as lessee. In lease transaction the right of the property are differentiated in two ways i.e. right to own and right to use. In other words lease is a contract between two parties, lessor and lessee. The lessor is the real owner of the property and the lessee obtains all the right to use the assets in return of regular rental payment.

Types of Lease:

A. Finance Lease

Finance lease is known as capital lease. In this type of lease the lessor transfer the title to the lessee at the end of the lease period and at the price agreed at the beginning of the lease. The lessee has the option to buy the assets at the end of the lease period. The finance lease cannot normally be cancelled. Present value of the minimum lease payments at the inception of lease exceeds or is substantially equal to the whole of the fair value of the leased assets. In case of finance lease, all the risks incidental to the ownership of the assets and the benefit there from are transferred to the lessee except the legal title which may or may not be transferred. The lessee has also to bear the cost of insurance, repairs and maintenance related to assets.
B. Operating Lease

An operating lease is a short term lease in which lessee agree to pay rent for the use of assets to the lessor. In operating lease lessee is having right to use the leased property for the limited period of time. It does not give to the lessee all benefits and risks that are associated with the assets. The lessor is responsible for the maintenance of the assets, insurance and all other relevant expenditure. An operating lease is generally preferred in the following circumstances.

a) Where there is a possibility of rapid obsolescence of the assets.
b) Where the lessee is interested in tiding over a temporary problem.

The operating lease is also termed as an open and lease arrangement since the lessee has the option to terminate the agreement by notice.

**Difference between Financial Lease and Operating Lease**

<table>
<thead>
<tr>
<th>Points of difference</th>
<th>Financial Lease</th>
<th>Operating Lease</th>
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<tbody>
<tr>
<td>Meaning</td>
<td>A Financial lease is a commercial contract in which the lessor lets the lessee use an asset in lieu of periodical payments for the usually long period.</td>
<td>An Operating lease is a commercial contract where the lessor allows the lessee to use an asset in lieu of periodical payments for a small period of time.</td>
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<td>Ownership</td>
<td>In Financial lease the ownership of the assets is transferred to the lessee.</td>
<td>In operating lease the ownership of the assets remains with the lessor.</td>
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<td>Period</td>
<td>Financial lease is a contract for long period</td>
<td>Operating lease is a contract for a short period.</td>
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<tr>
<td>Nature</td>
<td>The contract of financial lease is called as loan agreement.</td>
<td>The contract of operating lease is called as rental agreement.</td>
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<td>Maintenance of assets</td>
<td>In the case of a financial lease, the user would need to take care and maintain the asset.</td>
<td>In the case of operating lease, the owner would need to take care and maintain the asset.</td>
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</table>
Hire Purchase and Installment

Hire purchase system is the system wherein, the seller of the goods delivers the goods to the buyer without transferring the ownership of the goods. The payments for the goods will be paid by the purchaser in installments. The installments are may be weekly, monthly, quarterly or six monthly. Under this system the goods are transferred to the purchaser at the time of transaction but, the ownership will transferred after the payment of last installments. It means when buyer paid the entire installment to seller, then only the ownership of the goods will be transferred. The unique feature of hire purchase system is that the payment of every installment is treated as the payment of hire charges by the purchaser to the hire vendor.

A contract of hire purchase is a contract where goods are purchased or sold without the stipulation that the delivery of goods will be given by the owner of the goods to the hire purchaser, the payment of the price for the goods will be made in installments, ownership of the goods passes to the hire purchaser only on payment of all the installments and in the events of the hire purchaser’s failure to pay any installment, the hire vendor will be entitled to seize the goods and adjust the money paid by the hire purchaser against the hire charges for use of goods.

Hire purchase is the method of financing of the fixed assets to be purchased on future date. Under this method of financing, the purchase price is paid in installments. Ownership of the assets is transferred after the payment of the last installment.

Thus, hire purchase means a transaction where the goods are sold by the vendor to the purchaser under the following conditions.

- The goods will be delivered to the purchaser at the time of agreement
- The purchase has a right to use the goods without transfer of ownership.
- The price of the goods will be paid by the purchaser in the installments
- Every installment is treated as hire charges.
- If all installments are paid as per the terms of agreement, the title of the goods is transferred by vendor to purchaser.
• If there is any default in the payment of any of the installments, the vendor will take away the goods from the possession of the purchaser without refunding him any amount received earlier in the form of various installments.

Hire purchase agreement

The Hire Purchase Act, 1972 was enacted by the parliament to define the regulate rights and duties of the parties of the hire purchase. The Act was to be enforced from 1st September 1973. However due to objections from various sections of public, the Act remained in dormant state in the statute book and was never enforced. The hire purchase Act was finally repealed w.e.f. 23rd June 2005 by enactment of The Hire Purchase (Repeal), Act 2005.

A contract of Hire Purchase is now governed by the provisions of Chapter IX of the Indian Contract Act, 1872. Chapter IX deals with Contracts of Bailment. A bailment is the delivery of goods by the one person to another for some purpose, under the contract that they shall, when the purpose is accomplished, be returned disposed of according to directions of the persons delivering them. A hire purchase agreement is also a form of bailment in which the hirer is given the right to purchase only on certain terms and conditions. However, to purchase is only an option, not an obligation. If the hirer elects to purchase the goods, the title will pass to him once he fulfills all the conditions prescribed in the agreement. In case he does not elect to purchase the goods, he is entitled to return the goods and terminate the agreement in the manner provided therein.

Hire purchase agreement means the contract between the hire vendor and the hire purchaser. Hire vendor is the seller of the goods and hire purchaser is the purchaser of the goods. Following are contains include in the hire purchase agreement.

• The amount of down payment if hire purchaser paid on the delivery of the goods.
• The total hire purchase price paid under the agreement
• The date on which the hire purchase agreement is commenced.
• Description of the goods that will be transferred to the hire purchaser.
• The number of installments paid by the purchaser.
• The amount of installments with date of installments.
Royalty:

Royalty means a payment in the nature of rent made by one person to another person for using certain assets which belongs to latter. In other words Royalty means a periodically payment made by towards the use of certain fixed assets by the user to its owner. Royalty is the payment made by user of the assets to the owner periodically with consideration. The user of assets called as lessee or tenant and the owner of assets is called as lessor or landlord. In other words royalty is the payment made for having privilege of using some right. These rights are as follows.

a) Rights to extract some minerals from mine such as oil, coal, stone etc.
b) Rights to use certain patents for the manufacturer of articles for sales.
c) Rights to publish and sales books under copyrights.

There are three basics types of the Royalties.

i. Mining Royalty
ii. Patents Royalty
iii. Copyright Royalty

Royalty is the expenditure of Lessee, where it is an income of landlord. Mining and patents royalties are payable on production where copyright royalties are payable on sales.

Important Terms:

1. Lessee/Tenant/ User
2. Lessor/Landlord
3. Agreement
4. Rate of Royalty
5. Minimum Rent/ Dead Rent
6. Short working
7. Surplus
8. Recoupment of Short working
1. **Lessee/Tenant/user**

Lessee is the person who takes assets from landlord for use. Lessee is the user of the property. He makes payment to landlord as royalty. Royalty is the expenditure of the lessee.

2. **Lessor/Landlord**

Landlord is the real owner of the property or assets. He has transferred the right of use of assets to another person i.e. lessee. Landlord has received the rent from lessee in consideration of assets called Royalty. Royalty is the income of landlord.

3. **Agreement**

The agreement between the lessee and landlord of lease is called as lease agreement. This agreement includes the terms and conditions of the utilization of the property or assets. Generally the lease agreement include rate of royalty, lease period, recoupment of shortworking, minimum rent etc.

4. **Rate of Royalty**

The rate of royalty is required to calculate the actual amount of royalty which is payable to landlord. The rate of royalty is useful to calculate the amount of royalty. The amount of royalty is calculated as follows.

\[ \text{Royalty} = \text{Output} \times \text{Rate of Royalty} \]

5. **Minimum Rent/ Dead Rent**

Minimum rent is the fixed amount paid by lessee to landlord irrespective of the output per year.

6. **Shortworking**

When the amount of royalty is less than the amount of minimum rent the difference is called as surplus. It is calculated as follows.

\[ \text{Shortworking} = \text{Minimum Rent} - \text{Royalty} \]
7. **Surplus**

When the amount of royalty is more than the amount of minimum rent the difference is called as surplus. It is calculated as follows.

\[ \text{Surplus} = \text{Royalty} - \text{Minimum Rent} \]

8. **Recoupment of Shortworking**

It is the provision in the lease agreement that to adjust or recoup shortworking in future, when there is the surplus. The shortworking can be recouped as follows.

- Recoupment of shortworking during next \-------- year.
- Recoupment of shortworking during the first \-------- year.

**Accounting Treatment**

A. Preparation of Royalty Chart
B. Journal entries in the books of Lessee
C. Journal entries in the books of Landlord
D. Preparation of ledger A/c

### A. Chart of Royalty

<table>
<thead>
<tr>
<th>Year</th>
<th>Output</th>
<th>Minimum Rent</th>
<th>Royalty</th>
<th>Shortworking</th>
<th>Surplus</th>
<th>Recoupment</th>
<th>Shortworking Laps</th>
<th>Amount payable</th>
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Journal entries in the books of Lessee (Entries without Minimum Rent Account)

A. When there is only Shortworking, but no recoupment and irrecoupment.

1. When Royalty Payable.
   Royalty A/c--------------Dr (Amount of Royalty)
   Shortworking A/c --------Dr (Amount of Shortworking)
   To Landlord A/c (Amount Payable)
   (Being Royalty Payable)

2. When Minimum Rent Paid
   Landlord A/c--------------Dr (Amount Payable)
   To Bank A/c (Amount Payable)
   (Being Minimum Rent Paid)

3. When the amount of Royalty transferred to Profit and Loss A/c
   Profit & Loss A/c -----------Dr (Amount of Royalty)
   To Royalty A/c (Amount of Royalty)
   (Being amount of Royalty transferred to profit and loss A/c)

B. When there is no Shortworking, but there is surplus, recoupment and irrecoupment.

1. When Royalty Payable.
   Royalty A/c--------------Dr (Amount of Royalty)
   To Shortworking A/c (Amount of Recoupment)
   To Landlord A/c (Amount Payable)
   (Being Royalty Payable)

2. When Minimum Rent Paid
   Landlord A/c--------------Dr (Amount Payable)
   To Bank A/c (Amount Payable)
   (Being Minimum Rent Paid)

3. When the amount of Royalty transferred to Profit and Loss A/c
   Profit & Loss A/c -----------Dr
   To Royalty A/c (Amount of Royalty)
   To Shortworking A/c (Amt. of Irrecoup. Shortworking)
   (Being amount of Royalty transferred to profit and loss A/c)
C. When there is only Surplus

1. When Royalty Payable.

Royalty A/c----------------------Dr (Amount of Royalty)
   To Landlord A/c (Amount Payable)
(Being Royalty Payable)

2. When Minimum Rent Paid

Landlord A/c--------------------Dr (Amount Payable)
   To Bank A/c (Amount Payable)
(Being Minimum Rent Paid)

3. When the amount of Royalty transferred to Profit and Loss A/c

Profit & Loss A/c -------------Dr
   To Royalty A/c (Amount of Royalty)
(Being amount of Royalty transferred to profit and loss A/c)

Journal entries in the books of Landlord (Entries without Minimum Rent Account)

A. When there is only Shortworking, but no surplus, recoupment and irrecoupment.

1. When Royalty Receivable.

Lessee A/c ----------------------Dr
   To Royalty A/c
   To Shortworking A/c
(Being Royalty Receivable)

2. When Minimum Rent received

Bank A/c ------------------------Dr
   To Lessee A/c
(Being Minimum Rent received)

3. When Royalty transferred to Profit & Loss A/c

Royalty A/c---------------------Dr
   To Profit & Loss A/c
(Being Royalty Transferred to Profit and loss A/c)
B. When there is no Shortworking, but there is surplus, recoupment and irrecoupment.

1. When Royalty receivable

   Lessee A/c --------------------Dr
   Shortworking A/c------------Dr
   To Royalty A/c

   (Being Royalty receivable)

2. When Minimum Rent Received

   Bank A/c -------------------Dr
   To Lessee A/c

   (Being Minimum rent received)

3. When Royalty & Shortworking transferred to profit and loss A/c

   Royalty A/c------------------Dr
   Shortworking A/c------------Dr
   To Profit & Loss A/c

   (Being Royalty transferred to profit and loss A/c)

C. When there is only surplus

1. When Royalty receivable

   Lessee A/c ------------------Dr
   To Royalty A/c

   (Being Royalty receivable)

2. When Minimum Rent Received

   Bank A/c -------------------Dr
   To Lessee A/c

   (Being Minimum rent received)

3. When Royalty transferred to profit and loss A/c

   Royalty A/c-------------------Dr
   To Profit & Loss A/c

   (Being Royalty transferred to profit and loss A/c)