

# Accounting for rescheduling of lease rentals

*The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.*

## A. Facts of the Case

1. A non-listed company registered under the Companies Act, 1956 (hereinafter referred to as 'the company'), is a subsidiary of a listed public limited company. The company is a Non-Banking Financial Company (NBFC) registered with the Reserve Bank of India. The company has a network of branches over a large part of India to carry on its business and hence, takes on lease, various properties for its branches. The company is not in the business of leasing and renting.
2. The querist has stated that the company has entered into a lease agreement which has the following main features:
  - (i) The lease agreement is for a period of nine years.
  - (ii) The rent for the first three years is at market rate on the date of lease agreement and has an escalation clause applicable after every three years.
  - (iii) The lessee has the option to exit from the agreement by giving three months' notice.
3. The querist has stated that in the current scenario, the real estate rates in India as well as abroad have undergone various changes due to global financial meltdown and the fall in the equity markets. The property rates have gone down substantially in the range of 30% to 40% and are expected to go down further. Consequently, the rent agreed initially has turned out to be substantially high with respect to the current circumstances. The company has been successful in renegotiating the lease rentals of its premises downwards. The issue has arisen as to the accounting for lease rentals with respect to the lease period.
4. The original lease deed was entered into on 5.10.2006. The original and renegotiated terms of the contract are as follows:  
*Original lease deed:*

| Term                     | Rent                |
|--------------------------|---------------------|
| 20.11.2006 to 19.11.2009 | ₹ 70,000 per month  |
| 20.11.2009 to 19.11.2012 | ₹ 80,500 per month* |
| 20.11.2012 to 19.11.2015 | ₹ 92,575 per month* |

 (\*escalation of 15%)

The lessor was paid rent upto 31<sup>st</sup> December, 2008. The lease deed was renegotiated and the revised supplementary lease deed was entered into on 16.02.2009. The revised terms of the lease deed are as follows:

|                          |                     |
|--------------------------|---------------------|
| 01.01.2009 to 31.12.2009 | ₹ 56,000 per month  |
| 01.01.2010 to 31.12.2013 | ₹ 61,600 per month* |
| 01.01.2014 to 19.11.2015 | ₹ 67,760 per month* |

(\*escalation of 10%)

5. The company has accounted for lease rentals since the inception of the lease on a straight line basis with respect to the original lease term. The querist has reproduced the following paragraphs of Accounting Standard (AS) 19, 'Leases', which, according to the querist, have an impact on the issue at hand:

***"3.6 The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise."***

***"23. Lease payments under an operating lease should be recognised as an expense 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 of the user's benefit."***

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis."

6. According to the querist, the accounting for lease rent escalations would be governed by paragraph 23 of AS 19. As per the querist, in accordance with paragraph 23, an entity should account for lease rentals in the following

manner, which should be recognised as an expense in the statement of profit and loss:

- (i) on a straight line basis over the lease term, or
- (ii) another systematic basis if it is more representative of the time pattern of the user's benefit.

The querist has stated that in the given case, the lease term would be the entire nine year period as the entity has already decided the same at inception.

7. The querist has stated that the benefit that is derived by leasing a property can be generally measured from the market rates for similar properties. For example, if the market rate of a property in a year is ₹100, the benefit derived from the property is ₹100. In case the market rate falls to ₹80 in the next year, the benefit derived would be ₹80. Accordingly, under the current circumstances, the company believes that the fact that it will derive the same benefit throughout the lease term does not hold good due to the changed circumstances of a significant fall in the market rates.
8. The querist has also stated that in the current scenario, since the company has been able to successfully renegotiate rent, it can be reasonably assumed that the rent actually paid by the company reflects the benefit that accrues to the entity and accordingly, the rents actually paid should be debited as expense to the profit and loss account. Further, the company feels that the current scenario is such that the terms in the lease deed have a very high probability of being renegotiated in future. Thus, in the view of the querist, the aforesaid agreed rentals in the agreement are likely to be renegotiated as a further fall is expected.

## B. Query

9. Under the aforesaid facts and circumstances, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
  - (i) Whether the principle of recognising lease rentals over the lease term on a straight line basis is correct. If not, then what should be the basis of accounting for such lease rentals.
  - (ii) Whether the monthly rental should be accounted for at the value of actual lease rent paid in such a case.

## C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting for lease rentals in the case of an operating lease, where the company has

been successful in renegotiating/amending the lease rentals over the remaining period of lease and where it is expected that the terms in the lease deed have a high probability of being renegotiated in future. The Committee has, therefore, considered only this issue and has not touched upon any other issue that may arise from the Facts of the Case, such as, propriety of determining the lease in the present case as an operating lease as per the requirements of AS 19, legal implications, if any, arising out of such renegotiations in the lease deed, etc.

11. The Committee notes paragraph 23 of AS 19 as reproduced by the querist in paragraph 5 above. The Committee is of the view that as per the principles of AS 19, any departure from the straight-line basis of recognition of lease expense under an operating lease must reflect the time pattern of the user's benefit, which, in the view of the Committee, should be considered from the angle of use of the leased asset in physical terms rather than the benefit derived from the angle of market rates of leased properties as being argued by the querist. Since the leased property in the instant case would be used by the lessee throughout the lease term on a consistent basis, even though the lease rentals have been reduced due to economic slow down, the Committee is of the view that the lease expense over the lease term should be recognised on a straight line basis. The Committee also notes that volatility in the lease rentals due to economic changes or the expectations that the lease rentals would further go down does not affect the physical use of the property and, therefore, such considerations cannot form the basis for any departure from the straight line basis of recognition of lease rentals over the lease term in case of an operating lease. Also, the Committee is of the view that since the terms of a lease deed are legally binding on both the parties to the agreement, merely an expectation of deviation from the terms of the lease deed in future should not be considered while accounting for lease rentals.
12. With respect to accounting for lease rentals in the case of the existing operating lease, the Committee notes that due to economic changes, lease rentals have been re-negotiated and for the revised terms of the contract, a supplementary lease deed has been entered into. The Committee is of the view that for the purpose of accounting, the revised lease rentals should be taken into account for determining the charge to the profit and

loss account over the lease period of 9 years. Keeping in view the requirement of straight line basis for recognition of lease rentals over the lease term as per paragraph 23 of AS 19 as discussed in paragraph 11 above, the Committee is of the view that lease rentals payable over the whole period of nine years should be considered for determining the annual charge to the statement of profit and loss on this account. Accordingly, the lease rentals paid under the original lease deed and the revised lease rentals payable over the remaining period of the lease as per the supplementary lease deed, should be considered for determining the amount of annual charge on account of lease rentals on straight line basis. Any resultant adjustments on account of lease rent already recognised in past should be recognised in the current year's profit and loss account.

#### D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 9 above under the facts and circumstances of the case:
- (i) The principle of recognising lease rentals over the lease term on a straight line basis is correct.

- (ii) The monthly rental cannot be accounted for at the value of actual lease rent paid. See paragraphs 11 and 12 above.

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| 2 | The Opinion is based on the facts supplied and in the specific circumstances of the querist.                                                                                                                                                                                                                                                                                     |
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- Editor