

Classification of Buildings into Freehold and Leasehold in the Schedule of Fixed Assets

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

A. Facts of the Case

1. A company is a public sector undertaking registered under the Companies Act, 1956. The Government has recognised the company as a Public Financial Institution under section 4A of the Companies Act, 1956.

2. The company owns freehold/leasehold buildings. A consistent practice is being followed whereby the freehold/leasehold buildings owned by the company are disclosed under the head 'Buildings' in the schedule of fixed assets forming part of accounts. No segregation into leasehold and freehold is made in respect of buildings. These buildings have been acquired from the local authority/private builders on payment of lumpsum amount which includes cost of land also. In case land has been acquired separately and is leasehold, such land is shown in the fixed assets schedule as leasehold land. If a building is constructed thereon by the company, its cost is shown under the head 'Buildings' without classifying the same as leasehold or freehold. The accounting policy followed by the company in respect of fixed assets/depreciation is stated as below:

- (a) Depreciation is provided on written down value method, in accordance with the rates specified in Schedule XIV to the Companies Act, 1956.
- (b) Cost of leasehold land is amortised over the period of lease on straight-line basis.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 21 volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

- (c) Flats/buildings are capitalised at cost including the registration charges, etc., and the total value so arrived at is shown under the head 'Flats/Buildings' till separate details of cost of land and building are received. On receipt of such details, cost of building and land is apportioned.
- (d) Payments made for land/buildings/flats where allotment-cum-possession and execution of lease deeds are pending are being shown under the head 'Advance against Capital Purchases'.

3. The querist has stated that keeping the above in view, when it is known whether the land is leasehold or freehold, it is shown as 'leasehold' or 'freehold' as the case may be, and depreciation is charged, if applicable. The cost of building is shown under the head 'Buildings' without classifying the same as leasehold/freehold.

4. During the course of audit of accounts of the financial years 2000-2001 and 2001-2002, a query has been raised by the Comptroller and Auditor General of India that the cost of buildings which are acquired on leasehold/freehold basis should have been shown separately under the head 'Buildings (Leasehold)' and 'Buildings (Freehold)' respectively.

5. According to the querist, since there is no statutory requirement of classification of buildings into leasehold and freehold, a consistent policy over the years has been followed whereby only land is classified into leasehold and freehold, and no classification into leasehold and freehold is made in respect of buildings.

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether there is any statutory requirement as per the Companies Act, 1956, for classification of buildings as 'leasehold' and 'freehold'. If so,

whether it is necessary to indicate the lease period for such buildings by way of a 'note'.

- (ii) If the buildings have to be so classified, whether the depreciation would be charged differently on leasehold buildings and on freehold buildings.
- (iii) In case no information is available as to whether the building is freehold or leasehold, then how the same should be shown in the fixed assets schedule.
- (iv) Whether any accounting policy is to be framed for the above by the company.

C. Points considered by the Committee

7. The Committee restricts itself to the particular issues raised in paragraph 6 above, primarily, whether buildings should be classified as freehold and leasehold. Accordingly, the Committee has not examined any other issue(s) that may be contained in the facts of the case, such as, whether it is appropriate to disclose acquisition of flats/buildings which is inclusive of cost of land, under the head 'Buildings' till the receipt of details of respective costs, as those issues have not been raised by the querist.

8. The Committee notes that the form of balance sheet prescribed under Part I of Schedule VI to the Companies Act, 1956, states as follows:

“FIXED ASSETS

Distinguishing as far as possible between expenditure upon (a) goodwill, (b) land, (c) buildings, (d) leaseholds, (e) railway sidings,.....”

Thus, Schedule VI to the Companies Act, 1956, requires separate disclosure of leasehold assets as far as possible. It does not state that only the leasehold 'land' should be disclosed as 'leaseholds'. Leaseholds, thus, can be buildings obtained on lease, provided it is appropriate to account for the said buildings as the assets of the lessee as discussed in the following paragraphs.

9. The Committee also notes that sub-sections (3A) and (3C) of section 211 of the Companies Act, 1956, state as below:

“(3A) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.”

“(3C) For the purposes of this section, the expression “accounting standards” means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered

Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A:

Provided that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section.”

In view of the above, the Accounting Standards issued by the Institute of Chartered Accountants of India, are required to be followed by the querist as it is a company registered under the Companies Act, 1956.

10. The Committee notes that the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 19, 'Leases', which deals with accounting for assets acquired under lease agreements. The Committee notes that AS 19 distinguishes between 'finance leases' and 'operating leases' and in case, lease of an asset can be considered as a finance lease, within the meaning of the Standard, it is required to be disclosed as the asset of the lessee. Since the company in question is disclosing the buildings obtained on lease in its balance sheet, the Committee presumes that the lease of the said buildings constitutes a finance lease within the meaning of AS 19. The Committee notes that paragraph 22 of AS 19 which deals with the disclosure requirements in respect of finance leases in the financial statements of lessees requires as follows:

“22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;

.....”

11. From the above, the Committee is of the view that keeping in view the disclosure requirement set out in AS 19, the buildings should be disclosed as 'leasehold' or 'freehold', as the case may be, in the schedule of fixed assets.

12. In respect of depreciation charge on the leasehold assets, the Committee notes paragraph 18 of AS 19, which states as below:

“18. A finance lease gives rise to a depreciation

expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. 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 lease term or its useful life, whichever is shorter.”

13. The Committee also notes the disclosure requirements prescribed in paragraph 29 of Accounting Standard (AS) 6, ‘Depreciation Accounting’, issued by the Institute of Chartered Accountants of India, which is reproduced below:

“29. The following information should also be disclosed in the financial statements along with 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.”*

14. On the basis of paragraph 18 of AS 19, reproduced above, the Committee is of the view that the depreciation policy for leasehold buildings should be consistent with that for freehold buildings, and the depreciation charge should be calculated on the basis set out in AS 6. However, if there is no reasonable certainty that the company would obtain ownership of the leasehold building by the end of the lease term, the leasehold building should be fully depreciated over the lease term or the useful life of such building, whichever is shorter. The useful life of the building should be determined in accordance with the requirements of AS 6, according to which the rates specified in Schedule XIV to the Companies Act, 1956, or a higher rate, where the management’s estimate of the useful life is shorter than that arrived at as per Schedule XIV. In view of the requirements of paragraph 29 of AS 6 reproduced above, the useful life (or the lease term) or the depreciation rate applied should be disclosed for such leasehold buildings if the rate is different from the rate specified under Schedule XIV to the Companies Act, 1956.

15. The Committee is also of the view that on the balance sheet date, it should be ascertained from the relevant documents, e.g., purchase/lease agreement as to whether the

acquired building(s) is/are freehold or leasehold and the same should be disclosed accordingly.

16. The Committee notes paragraphs 11 and 18 of Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’, issued by the Institute of Chartered Accountants of India, which state as below:

“11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.”

“18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.”

From the above, the Committee is of the view that the company should frame an appropriate accounting policy keeping in view the points stated above and should disclose the same in accordance with AS 1.

D. Opinion

17. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6:

- (i) There is a statutory requirement as per the Companies Act, 1956, to disclose leasehold buildings separately in the schedule of fixed assets. For disclosure of lease period of leasehold buildings, please refer to paragraph 14 above.
- (ii) The depreciation policy for leasehold buildings should be consistent with that for freehold buildings, and the depreciation charge should be calculated on the basis set out in AS 6. However, if there is no reasonable certainty that the company would obtain ownership of the leasehold building by the end of the lease term, the leasehold building should be fully depreciated over the lease term or the useful life of such building, whichever is shorter.
- (iii) On the balance sheet date, it should be ascertained from the relevant documents as to whether the acquired building(s) is/are freehold or leasehold and the same should be disclosed accordingly in the schedule of fixed assets.
- (iv) An appropriate accounting policy for the above should be framed by the company and disclosed in accordance with the requirements of AS 1.