

Query No. 11

Subject: *Whether the arrangement is in nature of Operating lease or Finance lease.¹*

A. Facts of the Case

1. M/s ABC has been constituted as a statutory authority under the Airports Authority of India Act, 1994. It has been created by merging the erstwhile International Airports Authority of India and National Airports Authority of India.

2. The querist has informed that the main functions of M/s ABC are as under:

- Control and management of the Indian airspace (excluding special user airspace) extending beyond the territorial limits of the country, as accepted by International Civil Aviation Organization (ICAO).
- Provision of communication, navigational and surveillance aids.
- Expansion and strengthening of operational areas, viz. runways, aprons, taxiways etc. and provision of ground based landing and movement control aids for aircrafts and vehicular traffic in operational area.
- Design, development, operation and maintenance of passenger terminals.
- Development and management of cargo terminals at international and domestic airports.
- Provision of passenger facilities and information systems in the passenger terminals.

3. M/s ABC operates 129 Airports comprising of 23 International Airports, 77 Domestic Airports, 9 Customs Airports and 20 Civil Enclaves at Defence Airfields. M/s ABC prepares its annual accounts as per the format notified by the Ministry of Civil Aviation vide notification dated 27th March, 2014 framed under the Airports Authority of India (Annual Report and Annual Statement of Accounts) Rules 2014 which is aligned to the format of accounts as per schedule III to the Companies Act, 2013 and all mandatory Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) are followed. The querist has further informed that the Comptroller and Auditor General of India (C&AG) is the sole auditor of M/s ABC.

4. The querist has further informed that M/s ABC has placed supply orders for 'supply, installation, testing, commissioning and comprehensive maintenance of X-Ray baggage inspection system (XBIS) for registered baggage and hand baggage on BOT (Build, Own and Transfer) model for 06 years at various airports in India to the following 2 supplier companies:

| | Name of the Company | Contract value |
|---|---------------------|------------------|
| 1 | Company 1 | Rs.110.41 crores |
| 2 | Company 2 | Rs. 46.99 crores |

(The copies of work orders in this regard have been separately supplied by the querist for the perusal of the Committee.)

¹ Opinion finalised by the Committee on 13.6.2019.

5. *Accounting treatment given by M/s ABC for the contracts under reference:* As the ownership of the asset as well as risks and rewards relating to the assets remain with the supplier during the term of lease (though there is a provision for transfer of assets to M/s ABC on successful completion of lease period of six years free of cost), M/s ABC has treated these contracts as operating lease considering the substance and the stipulations under Accounting Standard (AS) 19, 'Leases'.

6. *C&AG Para on the accounting treatment given by M/s ABC for these contracts in 2017-18 accounts while conducting the audit of annual accounts of M/s ABC for the financial year (F.Y.) 2017-18:*

C&AG while conducting the audit of annual accounts of M/s ABC for the F.Y. 2017-18 has observed that the contracts under reference should have been treated as finance lease considering the substance of the contract instead of operating lease as reckoned by M/s ABC. The Comments of C&AG and the management reply thereon are as follows:

Comments of C&AG:

“Half Margin No: 03
Balance Sheet
Assets
Non-Current Assets

As per Accounting Standard 19 'Leases', 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 may be finance lease or an operating lease and transaction and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

A lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

- (a) The lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) The lease term is for the major part of the economic life of the asset even if title is not transferred;
- (c) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee; etc.

In case of finance lease, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the lease. Further, 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; other asset is depreciated over the lease term or its useful life, whichever is shorter. If the above conditions are not fulfilled, the lease should be classified as operating lease.

(On review of records, it was noticed that M/s ABC vide its work order dated 22nd March 2017 awarded the work of supply, installation, testing, commissioning (SITC)

& comprehensive maintenance of XBIS (Registered Baggage and Hand Baggage) on BOT (Build, Own and Transfer) model for six years to two foreign companies at a total cost of Rs.157.40 crore. Further, review of contract reveals that as per terms and conditions of the contract, on successful completion of six years, the assets in serviceable condition shall be taken over by M/s ABC at free of cost, the term of the lease is for major part of the economic life of the asset and in the event of termination of the contract due to unsatisfactory performance/ poor maintenance, the equipment shall be taken over by M/s ABC for which the contractor shall be paid depreciated cost of the equipment minus 30 *per cent* of the lease amount from the total lease amount already paid to the contractor as penalty. The depreciation would be at the rate of 20 *per cent* per annum on the original cost of the equipment. Thus, as can be seen from above and considering the substance over legal form as stipulated in AS 19, the aforesaid transaction of procurement of XBIS on BOT basis should have been classified as finance lease instead of treating the same as operating lease.

This has resulted in understatement of 'Non-Current Assets' and 'Liability' by Rs.157.40 crore. Consequently, depreciation is understated by Rs.0.89 crore (Depreciation – Rs.8.66 crore minus R&M Expenses on XBIS already booked – Rs.7.77 crore) and profit for the year is also overstated to the same extent.

Moreover, the disclosure requirement as per AS 19 of disclosing the lease payments as not later than one year, later than one year and not later than five years and later than five years is also not made in the notes to the accounts.

The above facts and figures may please be confirmed, while furnishing the reply to the Half Margins within three working days.”

Management reply:

“In the given case the asset is owned by the supplier till the end of the lease term. Also, as per the terms of the Service Level Agreement (SLA) the risk attributable to the asset remains with the supplier. Attention is invited to the following clauses appearing in the SLA namely:

- a) Paragraph 9.1 read with 9.2: Contractor shall provide the serviceability of 99% on all the equipment on monthly basis. Penalty shall be levied for delay, beyond the prescribed time for serviceability of the equipment. In case of partial/complete failure of the equipment, on expiry of prescribed limit, recovery shall be made @125% of daily lease maintenance charges per XBIS.
- b) If the availability of the system or part thereof , is below 95% on monthly basis, continuously over a period 6 months, M/s ABC reserves right to terminate the contract.....’

Hence, in effect the risk resides with the supplier and he has to maintain high standards of serviceability at all times (99% on all equipment on monthly basis and ensure availability of equipment too).

As per AS 19:

- i) Paragraph 3.2: “A financial lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.”
- ii) Paragraph 3.3: “An operating lease is a lease other than a finance lease.”

Hence, as the ownership of the asset and the risk attributable to asset resides with the supplier during the term of lease and is obliged to ensure 99% serviceability of the equipment, the lease has been classified as operating lease in the books of M/s ABC.

As regards disclosing the lease payments it is assured that adequate disclosure as desired by the Audit will be made in the books of account from next F.Y. onwards.

In view of the above Audit is requested to kindly drop the Para.”

7. The querist has informed that while discussing the audit paragraphs issued by C&AG, an assurance was given by M/s ABC that in view of difference of opinion between M/s ABC and C&AG on the accounting treatment given for the contracts under reference, M/s ABC will refer the issue to the ICAI for its considered opinion and necessary action as per the opinion given by ICAI in this regard will be taken by M/s ABC in its annual accounts for the F.Y. 2018-19. (The copies of relevant clauses of the Agreement containing salient features have been supplied separately by the querist for the perusal of the Committee).

8. The querist has separately informed the following:

(a) The opinion is sought from the perspective of Accounting Standards, issued by the ICAI.

(b) The terms and conditions of the agreement/contract entered into in respect of XBIS with both the companies are same.

(c) With regard to whether at the inception of the lease, the present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset, the querist has stated that while considering the proposal of ‘Supply, Installation, Testing, Commissioning and Comprehensive Maintenance (SITC)’ of XBIS for administrative approval and expenditure sanctioned the present value of capital model cost and present value of BOT model cost were compared and the NPV of BOT model as worked out was economical. (Copy of the Board Note/Minutes in this regard has been provided separately by the querist for the perusal of the Committee.)

(d) The economic life of leased asset i.e. XBIS is nine years.

B. Query

9. In view of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the work orders issued by M/s ABC on the two supplier companies and subsequent contract entered into for Supply, Installation, Testing, Commissioning and Comprehensive Maintenance of XBIS (Registered and Hand Baggage) on BOT (Build, Own and Transfer) model for 06 years at various airports in India should be treated as operating lease or finance lease by M/s ABC.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to whether the afore-mentioned arrangement with the two supplier companies for XBIS machines (hereinafter referred to as ‘the asset’) is operating lease or finance lease. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, measurement of fair value of the leased asset and minimum leased payment, appropriateness of calculations of net present value as performed by M/s ABC while considering the proposal of SITC of XBIS, accounting for the servicing and maintenance of the equipment component, as embedded in the contract, etc. Further, since AS 19, issued by the Institute of Chartered Accountants of India (ICAI) has been referred to in the Facts of the Case and the querist has also separately informed that mandatory Accounting Standards as issued by ICAI are being followed by M/s ABC, the Committee has expressed its views, hereinafter in the context of Accounting Standards, issued by the ICAI only and not the Accounting Standards or Indian Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 or Companies (Indian Accounting Standards) Rules, 2015. The Committee also wishes to point out that the query has been raised in the context of work orders/contract issued by M/s ABC to/with two supplier companies, however, as confirmed by the querist, all the terms and conditions of the Agreement/Contract entered into in respect of XBIS with both the companies are same. Therefore, the Committee has examined various terms and conditions of the agreement/contract with the company 1 only and not for company 2.

11. The Committee notes the following clauses of the Agreement with the supplier company, as submitted by the querist:

Clauses from Tender documents forming part of the contract agreement with Supplier:

Section B: Terms & Conditions

“5 Delay & non-conformance

“5.1 In case of time schedule including approved delay with or without levy of liquidated damage, for late delivery of supplies or late completion of training, whichever if applicable, as contained in Para 2 & 3 above, not being adhered to, M/s ABC has shall have the right to cancel the order wholly or in part thereof, without any liability of cancellation charges and shall have right to procure the goods / services elsewhere in which case the bidder firm shall pay for the loss to M/s ABC the difference in the cost of goods procured elsewhere against price set forth in the purchase order with the bidder firm.

8. Termination of contract at purchaser’s initiative

8.1 M/s ABC reserves the right to terminate the contract either in part or in full due to the reason other than specified herein in this tender, in fact not for convenience. Then M/s ABC shall in such an event give THIRTY calendar days’ notice in writing to the bidder firm of their decision to do so.

13. PRICE

13.1 The bidder firm shall confirm that quoted prices shall be firm and subject to no escalation whatsoever till the validity period of the tender/contract.

16. TRANSFER OF ASSETS

M/s ABC shall take over all the equipment and accessories in fully serviceable condition at the end of the lease period at free of cost, and the successful bidder shall maintain the equipment and accessories for a period of SIXTY (60) days from the last date of end of lease period without any extra charges.

17.8 Even after supplementary FAT, if the equipment is found not in conformance to tender technical requirements stipulated in Section-C of this tender, then M/s ABC shall cancel the contract and shall resort to action given in Section B – Para 5, 6, 8 and 12.”

Section C: SOW, Technical and Qualitative Requirements of Tender Document

1.4 The system shall be designed for continuous operation. The design life of the equipment shall be a minimum of SEVEN years.

2. Scope of Work

2.1 The Scope of work includes Supply, Installation, Testing, Commissioning & Comprehensive Maintenance of X-Ray Baggage Inspection (Registered and Hand Baggage) at various Airports in India for SIX years under BOT (Built Own and Transfer) model as per terms, conditions and specifications of this tender. ...

...

The Lease period shall be for Six years. After successful completion of lease period, the equipments which shall be in serviceable condition, be taken over by M/s ABC at free of cost.

Scope of work also includes any up-gradation of the software, hardware for the equipments supplied, released by OEM during lease period. Any software patches required for satisfactory operation of the equipment shall be provided by the contractor, free of cost.

7.22 If at any stage the contractor fails to provide satisfactory service, M/s ABC shall terminate the contract by giving one month's notice and treated as unsatisfactory performance and dealt with as per the clause No. 7.32 (i) and 7.32 (ii).

7.32 i. In case of poor maintenance and unsatisfactory performance, M/s ABC shall terminate the contract by giving one month notice and debar the contractor for further participation in M/s ABC tender for the period of 03 (Three) years.

ii. In the event of termination of the contract due to unsatisfactory performance/ poor maintenance, the equipment shall be taken over by

M/s ABC for which the contractor shall be paid depreciated cost of the equipment minus 30% of the lease amount from the total lease amount already paid to the contractor as penalty. The depreciation is at the rate of 20 % per annum on the original cost of the equipment.

Section I: Eligibility Requirements

8. Eligibility details and undertakings

- 8.2 In case of OEM firm, proof of being Original Equipment Manufacturer (OEM) for the offered X-ray Baggage Inspection System shall be submitted. OEM firm shall also submit an undertaking (Annexure- X) that the offered product(s) are not declared obsolete or end-of-life by OEM, and shall undertake to provide spares, sales, service and software support, in India for the life-time of the equipment i.e. estimated to be SEVEN years.

Clauses of work order with company 1:

9.0 Service level agreement (SLA)

- “9.2 Penalty: Penalty shall be levied for the delay, beyond the prescribed time for serviceability of the equipment. In case of partial/ complete failure of the equipment, on expiry of prescribed time limit. Recovery shall be made @125% of the daily lease maintenance charges per XBIS per day for each XBIS from the quarterly bill of running quarter.
- 9.3 However, if suitable fully functional replacement is provided in place of faulty equipment within prescribe time, no penalty shall be levied. The original equipment has to be reinstated at site after the repairs at the earliest. The total penalty within the scope of this contract shall not exceed 10% of the total contract value.”

12. The Committee notes the following paragraphs from Accounting Standard (AS) 19, ‘Leases’, issued by the Institute of Chartered Accountants of India:

“5. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.”

“8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

- (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 which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain 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; and
- (e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which 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 fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- (c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.”

13. From the above, the Committee notes that the classification of lease depends upon the extent to which risks and rewards incident to ownership of a leased asset lie with lessor or lessee. Therefore, a key criterion to determine the type of lease is whether or not it transfers substantially all the risks and rewards incident to ownership. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Further, paragraphs 8 and 9 of AS 19 contains certain examples of situations and indicators which would normally lead to a lease being classified as finance lease, such as, transfer of ownership of the asset by the end of lease term, option to purchase the asset at the end of the lease term at a price sufficiently lower than the fair value at the date the option becomes exercisable, major part of the economic life of the asset is covered by the lease term, present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset, conditions for cancellation, gains or losses from the fluctuation in the fair value of the residual, continuation of lease for a secondary period at a substantially lower rent etc. Thus, classification of an arrangement as operating or finance lease requires exercise of

judgement based on evaluation of facts and circumstances in each case, by considering the indicators/factors enumerated above.

14. The Committee notes from the Facts of the Case that as per the terms and conditions of the work order/Agreement, M/s ABC shall take over asset at the end of lease period of six years, free of cost, as a result, the lease transfers ownership of the asset to the lessee by the end of the lease term, which is one of the key criteria of classification of leases into finance lease. Also, M/s ABC will use the asset for the entire economic life of the asset. Further, the payments decided in advance at the beginning of the lease are fixed and subject to no changes/escalation irrespective of any change in the value of the asset under lease. Thus, the resultant gain/loss from appreciation or depreciation in the value of the leased asset is borne by the lessee, viz., M/s ABC. Accordingly, the Committee is of the view that the rewards in the form of expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realization of residual value as enumerated in paragraph 5 of AS 19 vest with M/s ABC (lessee). The Committee also notes that in the extant case, the risks in the form of idle capacity of the leased asset also apparently vest with M/s ABC. Accordingly, the Committee is of the view that considering the above factors, the lease in the extant case would, in substance, satisfy the tests laid down in paragraphs 8 and 9 of AS 19 and hence, would need to be classified as 'finance lease' by M/s ABC, the lessee. The Committee is further of the view that the right of the lessee to cancel/terminate the lease and the clauses relating to 99% serviceability of the leased asset during the lease term (as being contended by the querist in favour of the factors to be considered for operating lease) are only protective clauses to ensure satisfactory performance of the leased asset during the term of the lease and merely on that basis, it cannot be said that the risk attributable to the asset remains with the supplier. Further, the ownership of the asset during the lease term is not a relevant factor for determining the type of lease under AS 19.

D. Opinion

15. On the basis of above, the Committee is of the opinion that the arrangement with the two supplier companies for XBIS machines in the extant case would, in substance, satisfy the tests laid down in paragraphs 8 and 9 of AS 19 and hence would need to be classified as 'finance lease' by M/s ABC, the lessee, as discussed in paragraph 14 above.
