

How to recognize initial direct cost incurred by lessor when granting finance lease?

A.A.J.Supeshala & P.M.C.Thilakarataa
jayanikln@gmail.com & lak@kln.ac.lk

Introduction

ABC Finance Plc is well reputed finance company in Sri Lanka which its principle activities include Leasing, Hire Purchases, Loans, Operating Leases, Pawn Brokering, Investment and other financial services. An issue related to finance leases is the focal point here. When granting Finance Leases, Company (lessor) has to incur initial direct cost such as commissions, legal fees and internal cost that are incremental and directly attributable to negotiating and arranging a lease. Such expenses recovered by processing charges from leasing customers had been recognized as other income by the company.

Discussion of the Issue

ABC Finance PLC had recognized this total income portion to the financial statement and not reduced the amount of income recognized over the lease term. But according to the accounting standard LKAS 17-Leases (sub sec.38)it is mentioned that, for Finance lease other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognized over the lease term. Therefore this accounting practice is a departure from LKAS 17 and demonstrated the contradiction of recognition of processing charge income to the financial statement of ABC Finance PLC. Because of this practice the amount of other

income had been overstated and provisions (liabilities) had been understated. And finally the company's financial statements do not give a true and fair view.

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Conclusions and Recommendations

By considering this wrong practice, it is concluded that this error on income recognition affects the company fair presentation of financial statements to their users. And finally it is recommended to recognize the income on initial direct cost incurred by the company (lessor) on behalf of negotiating and arranging finance leases to the customers should be identified over the lease period of the customers and correct the misstatements in recording processing charges income. Otherwise it is recommended to apply correct accounting treatments of recording income from processing charges prospectively. Further it is recommended to have close monitoring, reviewing evaluating procedures to test the adequacy and application of accounting treatments on these matters by the company compliance managers and other authorized accounting professionals responsible with regard to this transaction.