Chapter 5

Leasing

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INTRODUCTION

• A lease is a contractual arrangement between a lessor (owner of the property) and a lessee (renter of the property).
INTRODUCTION

• A lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time.

• Lessor is a person who conveys to another person (lessee) the right to use an asset in consideration of a payment of periodical rental, under a lease agreement.

INTRODUCTION

• Lessee is a person who obtains from the lessor, the right to use the asset for a periodical rental payment for an agreed period of time.

• A financing arrangement that provides a firm with the advantage of using an asset without owning it, may be termed as ‘leasing’
INTRODUCTION

Largest group of leased equipment involves:
- Information technology
- Transportation (trucks, aircraft, rail)
- Construction
- Agriculture

Mechanic of Lease Finance

Leasing

| Operating Lease | Financial Lease |
Mechanic of Lease Finance

Lease Financier

Lessor

Lessee

Operating Lease (OL)

Financial Lease (FL)

1. Parties to lease agreement
   - There are two parties to a lease agreement.
   - They are: the lessor and the lessee.

2. Lease Asset
   - Leasing is used for financing the use of fixed assets of high value.
   - The asset is the property to be leased out. It may include an automobile, an aircraft, plant and machinery, a building etc. However, the ownership of asset is separated from the use of the asset.
Characteristics of Lease

3. Lease term
   – The term of the lease is called the lease period.
   – It is period for which the lease agreement is in operation.
   – It is illegal to have a lease without a specified term.
   – On expiry of the lease period, the asset reverts to the lessor mentioned in the ‘operating lease’.

Characteristics of Lease

4. Lease rentals
   – Lease rentals constitute the consideration payable by the lessee as specified in the lease transaction.
   – Rentals are determined to cover such costs as interest on the lessor’s investment, cost of any repairs and maintenance that are part of the lease package, depreciation on the leased asset and any other service charges in connection with the lease.
Types of Lease

1. Financial Lease
   – A financial lease, also called ‘capital lease’, is a contract involving payment over an obligatory period, of specified sum sufficient in total to amortize the capital outlay, besides giving some profit to lessor.
   – According to IAS 17 “a financial lease is a lease that transfers substantially all the risk and rewards incident to ownership of an asset. Title may or may not eventually be transferred”

1. Financial Lease (Con’t)
   – A financial lease is noncancelable in nature.
   – The lessee is responsible for the maintenance of the asset leased.
   – The lease generally provides for the renewal of the lease on expiry of the lease contract.
Types of Lease

2. Operating Lease
   – An operating lease is any other type of lease whereby the asset is not fully amortized during the noncancelable period of the lease, where the lessor does not rely on the lease rentals for profits. It is basically an economic service.
   – It is a short-term lease on a period to period basis, the period of lease being less than the useful life of the asset.
   – The lease is cancelable at short-notice by the lessee.
Types of Lease

2. Operating Lease (Con’t)
   – The lessee has the option of renewing the lease after the expiry of the lease period.
   – It is the responsibility of the lessor to ensure maintenance, insurance, etc of the asset, which is chargeable by the lessor.
   – It is a high risk lease to the lessor, since it could be cancelled at any time.

Lease or Buy Decisions

• Example of lessors
  – Banks
  – Insurance companies

• Types of asset leased
  – Office equipment
  – Computers
  – Cars
  – Commercial vehicles
  – Aircraft
  – Ships
  – Buildings
Financial Lease Vs Operating Lease

Financial lease is different from operating lease in the following manner.

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Financial Lease</th>
<th>Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specificity</td>
<td>The asset leased out is use specific for the lessee</td>
<td>The asset leased out may be used commonly by a number of users in sequence</td>
</tr>
<tr>
<td>Ownership</td>
<td>The lessee bear the risk and rewards associated with the use of the asset leased.</td>
<td>The risks and rewards associated with the use of the asset leased is borne by the lessor.</td>
</tr>
<tr>
<td>Obsolescence Risk</td>
<td>The lessee bears the risk of obsolescence</td>
<td>The lessor bears the risk of obsolescence</td>
</tr>
<tr>
<td>Cancelability</td>
<td>The lease cannot be cancelled by either of the parties. The lessor is rather interested in rentals and not in the asset</td>
<td>The lease can cancelled at the option of the lessee and the lessor does not have difficulty of leasing the same asset to other willing lessees</td>
</tr>
<tr>
<td>Lease Period</td>
<td>The lease period usually coincides with the life of the asset, and may be broken into primary and secondary period.</td>
<td>Lease period is generally small, as the lessor intends to lease the same asset several time to various users.</td>
</tr>
</tbody>
</table>
Financial Lease Vs Operating Lease

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<td>Maintenance</td>
<td>The cost of repairs and maintenance are borne by the lessee; the lessor is merely a financier in the deal</td>
<td>The cost of repairs and maintenance are borne by the lessor</td>
</tr>
<tr>
<td>Payout</td>
<td>It is full payout lease where a single lease repays the cost of the asset, together with interest</td>
<td>It is usually a nonpay out lease, as the lessor is in the business of leasing the asset to various users several time.</td>
</tr>
</tbody>
</table>

Entries for Lease

- The issue of how to report leases is the case of substance versus form. Although technically legal title may not pass, the benefits from the use of the property do.

**Operating Lease**

- **Journal Entry:**
  - Rent expense \( xxx \)
  - Cash \( \) \( xxx \)

**Capital Lease**

- **Journal Entry:**
  - Leased equipment \( xxx \)
  - Lease liability \( xxx \)
Test for Financial Lease

To capitalize a lease, one or more of four criteria must be met:

1. Transfers ownership to the lessee.
2. Contains a bargain purchase option.
3. Lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
4. The present value of the minimum lease payments (excluding executory costs) equals or exceeds 90 percent of the fair value of the leased property.

Test for Financial Lease

Exercise: On January 1, 2010, Burke Corporation signed a 5-year noncancelable lease for a machine. The machine has an estimated useful life of 6 years and the present value of the lease payments is $36,144, which is equal to the fair market value of the equipment. There is no transfer of ownership during the lease term, nor is there any bargain purchase option.

Instructions:

(a) What type of lease is this? Explain.

(b) Prepare the journal entry to record the lease on January 1, 2010.
Test for Financial Lease

**Exercise:** (a) What type of lease is this? Explain.

**Capitalization Criteria:**
1. Transfer of ownership
   - **NO**
2. Bargain purchase option
   - **NO**
3. Lease term => 75% of economic life of leased property
   - **YES**
   - Economic life: 6 yrs.
   - Lease term: 5 yrs.
   - Ratio: 83.3%
4. Present value of minimum lease payments => 90% of FMV of property
   - **YES** - PV and FMV are the same.

**Test for Financial Lease**

**Exercise:** (b) Prepare the journal entry to record the lease on January 1, 2010.

- Leased asset - equipment: 36,144
- Lease liability: 36,144
Leasing Process

The process of leasing take the following steps:

1. Lease selection
   - The first step in a leasing transaction is the selection of the asset to be taken out on lease basis.
   - The lessee does this by giving due consideration to various requirements such as, lease payments and other factors.
   - A lease agreement is broadly negotiated.

2. Order and delivery
   - Based on the selection made by the lessee, the lessor goes about placing an order for the manufacture of the assets to be leased.
   - The manufacturer delivers the asset at the site of the lessee who, in turn, gives a notice of acceptance to the lessor.
Leasing Process

3. Lease Contract
   • Both the parties sign a lease agreement setting out details of the terms of the lease contract.
   • Leases will normally be full payout, with varying terms and conditions.
   • The usually lease period ranges from 3 to 5 years.

Leasing Process

4. Lease Period
   • During the currency of the lease period, the lessee will make lease payment at regular intervals, as agreed upon between the parties.
   • The lessee will ensure the proper upkeep and maintenance of the asset leased.
   • At the end of the lessee may either renew the lease or terminate the lease, and retreat the asset to the lessor, or may even acquire the asset from the lessor.
Question?