**Leasing: Definitions, Types, Merits and Demerits**

A “lease” is defined as a contract between a lessor and a lessee for the hire of a specific asset for a specific period on payment of specified rentals.

Lease finance can be said to be a **“contract between lessor and lessee whereby the former acquires the equipment/goods/plant as required and specified by the lessee and passes on the goods to the lessee for use for a specific place and in consideration promises to pay the lessor a specified sum in a specified mode at specific interval and at a specified place”.**

Under the lease financing, an asset can be acquired without incurring the initial purchase cost by just making payment of lease rentals over a specified period of the lease contract. It is more or less an off-balance sheet financing, where neither the acquisition of asset nor the loan is to be shown in the financial position statement.

The periodical lease rentals paid will be shown in the financial position statement as business expenditure. It is basically a contract whereby the owner of the asset (the lessor) grants to another party (the lessee) to exclusive right to use the asset for an agreed period of time, for an agreed amount payable on periodical basis (lease rentals) over the specified lease period.

The maximum period of lease according to law is for 99 years. Previously land or real resate, mines and quarries were taken on lease. But now a day’s plant and equipment, modem civil aircraft and ships are taken.

**Definition:**

**(i) Lessor:**

The party who is the owner of the equipment permitting the use of the same by the other party on payment of a periodical amount

**(ii) Lessee:**

The party who acquires the right to use equipment for which he pays periodically.

**Lease Rentals:**

**This refers to the consideration received by the lessor in respect of a transaction and includes:**

(i) Interest on the lessor’s investment;

(ii) Charges borne by the lessor. Such as repairs, maintenance, insurance, etc;

(iii) Depreciation;

(iv) Servicing charges.

At present there are many leasing companies such as 1st Leasing Company, 20th Century Leasing Company which are doing quite a lot of business through leasing, It has become an important financial service and a lucrative avenue of making sizable profits by leasing companies.

#### Features of Lease:

**The important features of lease contract are as follows:**

(a) The lease finance is a contract.

(b) The parties to contract are lessor and lessee.

(c) Equipment are bought by lessor at the request of lessee.

(d) The lease contract specifies the period of contract.

(e) The lessee uses this equipment’s for his own purpose.

(f) The lessee, in consideration, pays the lease rentals to the lessor.

(g) The lessor is the owner of the assets and is entitled to the benefit of depreciation and other allied benefits e.g., under sections 32A and 32B of the Income-tax Act.

(h) The lessee claims the rentals as expenses chargeable to his income.

The last two items are basically related to the accounting practice.

**Types/Classification of Leases:**

**The different types of leases are discussed below:**

**1. Financial Lease:**

This type of lease which is for a long period provides for the use of asset during the primary lease period which devotes almost the entire life of the asset. The lessor assumes the role of a financier and hence services of repairs, maintenance etc., are not provided by him. The legal title is retained by the lessor who has no option to terminate the lease agreement.

The principal and interest of the lessor is recouped by him during the desired playback period in the form of lease rentals. The finance lease is also called capital lease is a loan in disguise. The lessor thus is typically a financial institution and does not render specialized service in connection with the asset.

**2. Operating Lease:**

It is where the asset is not wholly amortized during the non-cancellable period, if any, of the lease and where the lessor does not rely for is profit on the rentals in the non- cancellable period. In this type of lease, the lessor who bears the cost of insurance, machinery, maintenance, repair costs, etc. is unable to realize the full cost of equipment and other incidental charges during the initial period of lease.

The lessee uses the asset for a specified time. The lessor bears the risk of obsolescence and incidental risks. Either party to the lease may termite the lease after giving due notice of the same since the asset may be leased out to other willing leases.

**3. Sale and Lease Back Leasing:**

To raise funds a company may-sell an asset which belongs to the lessor with whom the ownership vests from there on. Subsequently, the lessor leases the same asset to the company (the lessee) who uses it. The asset thus remains with the lessee with the change in title to the lessor thus enabling the company to procure the much needed finance.

**4. Sales Aid Lease:**

Under this arrangement the lessor agrees with the manufacturer to market his product through his leasing operations, in return for which the manufacturer agrees to pay him a commission.

**5. Specialized Service Lease:**

In this type of agreement, the lessor provides specialized personal services in addition to providing its use.

**6. Small Ticket and Big Ticket Leases:**

The lease of assets in smaller value is generally called as small ticket leases and larger value assets are called big ticket leases.

**7. Cross Border Lease:**

Lease across the national frontiers is called cross broker leasing. The recent development in economic liberalization, the cross border leasing is gaining greater importance in areas like aviation, shipping and other costly assets which base likely to become absolute due to technological changes.

**Merits of Leasing:**

(i) The most important merit of leasing is flexibility. The leasing company modifies the arrangements to suit the leases requirements.

(ii) In the leasing deal less documentation is involved, when compared to term loans from financial institutions.

(iii) It is an alternative source to obtain loan and other facilities from financial institutions. That is the reason why banking companies and financial institutions are now entering into leasing business as this method of finance is more acceptable to manufacturing units.

(iv) The full amount (100%) financing for the cost of equipment may be made available by a leasing company. Whereas banks and other financial institutions may not provide for the same.

(v) The ‘Sale and Lease Bank’ arrangement enables the lessees to borrow in case of any financial crisis.

(vi) The lessee can avail tax benefits depending upon his tax status.

#### ****Disadvantages of Leasing:****

On the base of their advantages the following Demerits or disadvantages of leasing below are:

* In leasing the cost of interest is very high.
* The asset reverts to the owner on the termination of the lease period and the lesser lose his claim on the residual value.
* Leasing is not useful in setting up new projects as the rentals become payable soon after the acquisition of assets.
* The lessor generally leases out assets that are purchased by him with the help of bank credit. In the event of a default made by the lessor in making the payment to the bank, the asset would seize by the bank much to the disadvantage of the lessee.

##### **Limited Financial Benefits:**

If paying lease payments towards land, the business cannot benefit from any appreciation in the value of the land. The long-term lease agreement also remains a burden on the business as the agreement locks and the expenses for several years are fixed. In a case when the use of assets does not serve the requirement after some years, lease payments become a burden.

##### **Reduced return for Equity Holders:**

Given that lease expenses reduce the net income without any appreciation in value, it means limited returns or reduced returns for an equity shareholder. In such a case, the objective of wealth maximization for shareholders not achieves.

##### **Limited TAX Benefits:**

For a new start-up, the tax expense is likely to be minimal. In these circumstances, there no adds tax advantage that can derive from leasing expenses.

## Kinds OF LEASE

Both IFRS and GAAP have different criteria for classifying the lease as finance or an operating lease:

* **IFRS:**If the lessee is entitled to all the risks and rewards that are related to ownership, the lease is categorized as a finance lease. The lessee needs to report the lease liability and the leased asset on the [balance sheet](https://efinancemanagement.com/financial-accounting/balance-sheet-definition-and-meaning). A lease not meeting the above criterion is categorized as an operating lease.
* **GAAP:**A lease is categorized as a finance lease if it meets even one of these following four requirements:
  1. If the lessee becomes the owner of the leased asset at the end of the lease.
  2. If the lease allows the lessee to purchase the same leased asset at a price which is less than the fair value of the asset in future.
  3. If the term of the lease is 75% or more of the leased asset’s useful life.
  4. If the present value of the lease payments is 90% or more of the fair market value of the asset.

**Accounting and Reporting by Lessee**

A lessee uses the leased asset and makes regular payments to the lessor. The accounting and reporting of different leases are done as follows:

## ACCOUNTING FOR FINANCE LEASE BY LESSEE

The finance lease is reported by the lessee as follows on different financial statements:

* **Balance Sheet:**Both leased asset and lease payable (liability) is reported. The value reported is lower of the present value of the lease payments in future or the leased asset’s fair market value.
* [**Income Statement**](https://efinancemanagement.com/financial-accounting/income-statement)**:**The interest expense on the lease payable is reported. It is calculated on the lease payable at the beginning using the implied interest rate in the lease. Generally, the interest rate used is lower of the borrowing rate of a lessee and the implicit rate of a lessor. If the leased asset is depreciable, then a [depreciation](https://efinancemanagement.com/financial-accounting/depreciation) expense is also reported as with any other asset.
* [**Cash Flow Statement**](https://efinancemanagement.com/financial-accounting/cash-flow-statement)**:**Under GAAP, the interest component of the [lease payment](https://efinancemanagement.com/sources-of-finance/lease-payment) is reported as an operating cash outflow. And the principal repayment component that reduces the lease payable is reported as a financing cash outflow. Under IFRS, the interest expense can be reported either an operating cash outflow or financing.

## ACCOUNTING FOR OPERATING LEASE BY LESSEE

The operating lease is reported by the lessee as follows on different financial statements:

* **Balance Sheet:**Neither an asset nor a liability is reported.
* **Income Statement:**The asset’s rent is expensed which is the same as the lease payment.
* **Cash Flow Statement:**The complete lease payment or the rent expense is reported as operating cash outflow.

## IMPACT OF LEASE ACCOUNTING ON LESSEE’S FINANCIAL STATEMENTS

The difference in accounting in both the leases – finance and operating impacts the various elements of the financial statements as below**:**

* Assets, liabilities, [net income](https://efinancemanagement.com/financial-accounting/net-income) in later years, operating income (EBIT) and cash flow from operations are higher in finance lease as compared to that in an operating lease.
* Net income in early years and cash flow from financing are lower in finance lease as compared to that in an operating lease.
* Though total income and total cash flow remain the same in both the leases.

## IMPACT OF LEASE ACCOUNTING ON LESSEE’S FINANCIAL RATIOS

As with financial statements, financial ratios are also impacted by the different leases:

* [Current ratio](https://efinancemanagement.com/financial-analysis/current-ratio), [working capital](https://efinancemanagement.com/working-capital-financing/working-capital), [asset turnover ratio](https://efinancemanagement.com/financial-analysis/asset-turnover-ratio-atr), [fixed asset](https://efinancemanagement.com/financial-accounting/fixed-asset) turnover ratio, [return on assets](https://efinancemanagement.com/financial-analysis/return-on-assets-roa) in early years and [return on equity](https://efinancemanagement.com/financial-analysis/return-on-equity-roe) in early years is lower in finance lease.
* Return on assets in later years, return on equity in later years, debt to assets ratio and [debt to equity ratio](https://efinancemanagement.com/financial-analysis/debt-to-equity-ratio) is higher in finance lease.

**Accounting and Reporting by Lessor**

## ACCOUNTING FOR FINANCE LEASE BY LESSOR

For the lessor, the finance lease is of two types under U.S.GAAP. If the present value of all the lease payments is same as the carrying value of the leased asset, such lease is called direct financing lease. If the present value of the lease payments is more than the carrying value of the leased asset, it is called a sales-type lease. Both these types of finance lease are reported by the lessor as follows on different financial statements:

* **Balance Sheet:**The lease receivable is reported. The value is derived from the present value of lease payments in future. Also, the assets are reduced by the book value of the leased asset.
* **Income Statement:**The interest revenue is reported. It is calculated on the lease receivable at the beginning using the interest rate in the lease.
* **Cash Flow Statement:**The interest component of the lease revenue is reported as an operating cash inflow and the principal component of the payment is reported as an investing cash inflow.

## ACCOUNTING FOR OPERATING LEASE BY LESSOR

The operating lease is reported by the lessor as follows on different financial statements:

* **Balance Sheet:**The leased asset is reported as always.
* **Income Statement:** The interest revenue is reported as well as the depreciation related to the asset is reported.
* **Cash Flow Statement:** The periodic lease payment is categorized as an operating cash inflow.

## IMPACT OF LEASE ACCOUNTING ON LESSOR’S FINANCIAL STATEMENTS

The financial statements of the lessor are impacted by the difference in both the leases in the following ways:

* The lease revenue and the total cash flow are similar under both the leases.
* Income in the early years is higher in finance lease than that of the operating lease.
* Income in the later years is lower in finance lease than that of the operating lease.
* The [operating cash flow](https://efinancemanagement.com/financial-accounting/operating-cash-flow) is lower in finance lease than an operating lease.
* The amount of taxes in the early years is higher in finance lease than an operating lease.

**Conclusion:** The accounting and reporting of a lease differ from the perspective of a[lessor and a lessee](https://efinancemanagement.com/sources-of-finance/lessor-and-lessee). It also further differs depending on the type of lease – finance or operating. Thus, it is imperative that the lease is properly categorized and reported as it has numerous implications on financial statements and financial ratios.