



Module-C Unit-8

JAIIB PAPER-3

Accounting & Financial Management for Bankers(AFM)



JAIB Paper 3 (AFM) Module C Unit 8- Equipment Leasing/ Lease Financing

Meaning Of Lease

- A lease is a contract under which one party agrees to allow use of its property to another party, for a specific period of time, on agreed payment terms. The party which owns the property is called Lessor and the party which gets right to use the asset, is called Lessee.
- The agreed payment for the right to use the property is called the lease rental. The property to be leased may be land, building, animal, industrial equipment or any other fixed or movable asset



Features Of A Lease

- **Legal:** It is a legal, binding contract containing the terms on which one party agrees to allow use of its property by another party.
- **Guarantees:** It guarantees the lessee use of the property and guarantees the lessor regular payments for a specified period, in exchange for allowing use of its property.
- A lease can be residential lease, which is normally same for all tenants, or commercial lease, which is often of various types.
- Breaking a lease contract involves legal consequences

Types Of Leases

As per Accounting Standard Ind AS 116, "A lessor shall classify each of its leases as either an operating lease or a finance lease".



Leveraged lease



TO PURCHASE AN ASSET

May Borrow all or majority of money

Owner

- 3 parties: the lessor, lessee, and the lender.
 - Out of each lease payment from the lessee, one portion is passed on to the lender for debt servicing and the other portion is received by the lessor. The leased asset is charged to the lender as also the lease rentals payable by the lessee.
- Domestic lease,**
 - All parties involved in lease transaction, are domiciled in India.
 - If any party is not domiciled in India, it is called an international lease or cross-border lease.
 - An international lease may have implications like country risk and currency risk.
 - A cancellable lease is one that can be cancelled as per the terms contained in the lease agreement.
 - A non-cancellable lease is one that is cancellable only upon the occurrence of some remote contingency or, with the permission of the lessor or, if the lessee enters into a new lease for the same or an equivalent asset with the same lessor.
 - A Wet lease is one in which the lessor operates the equipment and is responsible for its insurance, maintenance etc
 - In a Dry lease, all these functions are responsibilities of the lessee.

- ❑ Under a Sale and Lease-back transaction, the asset owned by one party is sold to the other party and simultaneously taken back on lease. So, practically, the possession does not change, only the ownership is transferred. This method is used to unlock value of assets of a firm. Sale and leaseback transactions came under a lot of criticism during 1990s, when transactions in junk assets were made at very high values and labeled as sale and leaseback transactions.

Finance Lease

- It is also known as capital lease or sale lease.
- lessor and lessee agree that the ownership of the leased asset will be transferred to the lessee on completion of the lease period.
- It is a method of providing finance where the lessor buys the asset, not for its own use but for use by the lessee, for an agreed period.
- Practically results in substantially transferring the risks and rewards of ownership of the asset to the lessee.
- Lessee own the leased asset for a major part of its economic life, without being its legal owner.



The accounting standard, Ind AS 116, defines a finance lease as: "A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset".

Illustration The situations under which a lease is normally classified as a finance lease are:

- The ownership of the asset is transferred to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price which is substantially lower than the fair value, and it is reasonably certain that the option will be exercised.
- The lease term is for the major part of the economic life of the asset.
- The present value of the minimum lease payments at the inception of the lease, amounts to substantial fair value of the leased asset, or more.
- The leased asset is of a such a specialised nature that it can be used only the lessee.

- The lessee has right to cancel the lease and the lessor's losses due to the cancellation, are borne by the lessee.
- The lessee has the right to continue the lease for a secondary period at a rent which is substantially lower than market rent.

Operating Lease

- **The accounting standard, Ind AS 116, defines an operating lease as:** "A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset".
- Lease classification is made at the inception date and is reassessed only if there is a lease modification.
- An operating lease is classified as wet lease if the lessor provides the know-how and related services for operating the asset and takes care of its insurance, maintenance etc.
- Otherwise, it is classified as dry lease

Illustration

- The lease term is substantially less than the economic life of the asset.
- The lessee has right to cancel the lease without paying any substantial penalties.

Rationale For Leasing

The borrowing capacity is not reduced:

- Leasing is useful to a lessee in strengthening its borrowing capacity and thereby permitting the firm to raise more debt capital, given the firm's existing equity base.
- Since the obligation created under the operating lease arrangement is not reflected as debt in the balance sheet, the firm's debt equity ratio does not deteriorate.
- However, under a finance lease, the accounting standards require the firm to include the value of assets and the resulting liability in the balance sheet.
- Lenders are also aware of the implications of the lease financing making it difficult for the lessee firms to increase their borrowing power.

Availability of full finance:

- Banks and financial institutions, normally, insist on substantial margin to be brought in by the firm, for purchasing an asset.
- In leasing, there is no such need and the firm gets the asset without arranging capital for margin money.
- Therefore, a firm experiencing shortage of funds can acquire assets more quickly under leasing arrangement than in buying.

Convenience:

- Lease financing, especially the operating lease, is regarded a more convenient form of acquiring an asset compared to purchasing that asset.
- This is even more relevant if the asset is to be used for short duration compared to its useful life, because the lessee has not to go through the tedious process of buying and then selling the asset.
- Also, the time taken for acquiring an asset through lease route is normally much less compared to that under purchase by arranging a term loan or other type of debt.

Avoiding risk of obsolescence:

- Improved designs and technological advances make present equipment inefficient and expensive to operate, compared to the newly developed equipment.
- Leasing offers the advantage of passing this risk of obsolescence to the lessor.

Tax Advantage

- Lease financing is also used by many firms as a tax planning device to reduce tax liability.
- Normally, the lessee firm is benefitted if it can charge off the cost of an asset more rapidly through lease rentals than through depreciation charges.

Financial Flexibility and cash flows:

- As the firm can choose from a variety of leasing products available, it can address its needs and requirements regarding cash flows, transaction structure, cyclical fluctuations, expansion plans, profitability etc., by selecting the most suitable products.
- Leasing allows a firm to match its cash outflow on rental payments for leased equipment, with its revenue receipts, in a better way.

Less restrictive covenants:

- The restrictive covenants on a lessee are much less if an asset is acquired through lease, compared to its acquisition through other means of financing.
- For example, a term lending institution or bank may put restrictions regarding payment of dividends, future expansion, managerial appointments, personal guarantees of promoter directors etc.

Contents Of A Lease Agreement

- The lease agreement is a written agreement between the lessor and the lessee stating the terms and structure of the lease.
- All the future actions of lessor and lessee, relating to the leased asset are guided by this agreement.
- Therefore, it is very carefully drafted envisaging all the future situations. Contents of a lease agreement are different for different assets and different

types of leases. A lease agreement typically contains the details relating to the following aspects:

Particulars of the Parties

In case of leveraged lease, tripartite agreement etc., third party information should also be included.

Description of the Asset:

This also includes details regarding scope and validity of manufacturer's warranty.

Equipment Delivery and Installation:

The agreement should clearly mention about the delivery and installation of equipment at the beginning, as also the end of the lease.

Primary Period, Effective Date and Renewal:

The agreement should be specific on these aspects.

Initial/ Security Deposit, Lease Rental and Payment Terms:

This also includes interest payable on security deposit, mode and frequency of payment, rent escalation clause and penalty in case of delay in payment of lease rental.

Transferability of ownership:

The agreement should mention regarding transfer of ownership at the end of the lease period.

Repair and Alteration:

The party which will bear the cost of repair and alteration, should be specified.

Insurance/ Government Dues:

The agreement should mention about who will pay the cost of insuring the asset, as also the municipal dues, property taxes, etc.

Sub-Lease/Restricted Activities:

The activities, including sub-lease of the asset, which are not permitted by the lessee, should be specified.

Surrender/Termination of Lease Agreement:

If the asset can be surrendered during the period of the lease, the penalties payable should be specified. Also, the circumstances, under which any party can terminate the agreement, details about the notice period and compensation should be specified.

Default and arbitration:

Details of consequences of default and arbitration should be specified.

Legal Aspects Of Leasing

- **Definition:** Transfer of Property Act and Indian Registration Act, covers only the property and not equipment.
- In absence of a separate law for equipment leasing: bailment in the Indian Contract Act may be construed to be applicable to equipment leasing contracts.
- As per this Act, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee, unless specified in the lease contract.

GST On Lease Transactions

As per Sec 7 of the CGST Act, 2017, the expression supply includes all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business.

From this, it is clear that the lease is covered within the meaning & scope of “supply” and it is taxable.

GST does not differentiate between a Finance lease and an Operating Lease. GST rates on lease transactions are as under:

- ✓ Nil rate on lease of industrial plots, provided by the State Government Industrial Development Corporations or Undertakings to industrial units and Leasing of Agro Machinery/ Vacant land.
- ✓ GST on Lease transactions which will be covered under the category of “Supply of Goods” and “Supply of Services” is chargeable at same rate as on supply of similar goods and services.

Income Tax Implications Of Lease

Income Tax rules do not differentiate between a Finance lease and an Operating Lease. Income Tax implications of a lease transaction are as under:

In a lease transaction, the lessor is eligible for depreciation on the asset, as he owns the assets. The lessee, therefore, will not be eligible to claim any depreciation.

In sale and leaseback transactions, income Tax rules permit depreciation on the sold asset’s depreciated value rather than the actual value of the sales transaction.

- ✓ The entire lease rentals are taxed as income of the lessor.
- ✓ The lessee is entitled to treat the rentals as expenses.

Accounting Of Lease Transactions In Books Of Lessor

Ind AS 116 prescribes the following in respect of Accounting of Lease Transactions in Books of lessee:

For Finance leases

- ✓ **Initial recognition:** At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as a receivable at an amount equal to the net investment in the lease.
- ✓ The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease.
- ✓ Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.
- ✓ A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.
- ✓ The implication of Ind AS 116 is that the leased asset is not capitalised in the balance sheet of lessor, despite being its owner. It is presented as a receivable equal to the net investment in the lease, which is the present value of lease rentals receivable from the lessee. The discount rate applied for calculating the present value is the interest rate implicit in the lease.

Illustration

ABC Ltd. purchases an equipment for Rs. 100 lakh and leases it to XYZ Ltd. for a period of 10 years. The initial cost incurred by ABC Ltd. in negotiating and arranging the lease is Rs. 6 lakh. Lease rental is Rs.18 lakh per year. The useful life of the machine is 10 years and the residual value of the equipment is nil. No initial payment is involved. The interest rate implicit in the lease is 10% p.a. How this lease will be treated in its books, by ABC Ltd.?

Answer:

The present value of the lease rentals of Rs.18 lakh per year, for 10 years is Rs. 6.145×18 = Rs. 110.61 lakh at the discount rate of 10% p.a. (by using the Annuity table, PVIFA = 6.145) Therefore, in the balance sheet of ABC Ltd, an amount of Rs. 110.61 lakh will be shown as receivables from the lease asset.

For Operating leases

- ✓ Lessors present assets, given under operating leases, in their balance sheet according to the nature of the asset.
- ✓ Initial direct costs incurred by lessors in negotiating and arranging an operating lease, are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.
- ✓ The depreciation policy for depreciable leased assets should be consistent with the lessor's normal depreciation policy for similar assets.
- ✓ Lessor should recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis.

- ✓ The lessor may apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

Illustration

ABC Ltd. purchases an equipment for Rs. 100 lakh and leases it to XYZ Ltd. for a period of 3 years. The initial cost incurred by ABC Ltd. in negotiating and arranging the lease is Rs. 6 lakh. Lease rental is Rs. 18 lakh per year. The useful life of the machine is 10 years and the company follows the policy of straightline method of depreciation. How this lease and rentals will be treated in its books, by ABC Ltd.?

Answer:

- The carrying cost of the equipment, in the balance sheet of ABC Ltd., will be Rs. 106 lakh (purchase cost of Rs. 100 lakh and initial cost of Rs. 6 lakh).
- The depreciation charged will be Rs. 10 lakh per year using the straight line method.
- The lease rental of Rs. 18 p.a. will be charged as expenses if straight line method of accounting for lease rentals is used.

Accounting Of Lease Transactions In Books Of Lessee

The distinction between a finance and an operating lease, as far as accounting treatment in the books of lessee is concerned, has been removed by Ind AS 116.

Ind AS 116 prescribes the following in respect of Accounting of Lease Transactions in Books of lessee:

- At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.
- At the commencement date, a lessee shall measure the right-of-use asset at cost.
- The cost of the right-of-use asset shall comprise:
 - ✓ The amount of the initial measurement of the lease liability,
 - ✓ Any lease payments made at or before the commencement date, less any lease incentives received,
 - ✓ Any initial direct costs incurred by the lessee; and,
 - ✓ An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.
- **Initial measurement of the lease liability, mentioned in 3 (a) above:** At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be

readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

- In the statement of profit and loss, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset.
- **Exemptions:** A lessee may elect not to apply the above accounting requirements to:
 - ✓ Short-term leases; and
 - ✓ leases for which the underlying asset is of low value

In case of opting for such exemption, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

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