EQUIPMENT LEASING/ LEASE FINANCING

LEASE

It is a financial arrangement in which **one party, known as the lessor**, agrees to **allow use of its property to another party**, known as the **lessee**, in exchange for **periodic lease payments** over a specified period.

PARTIES IN LEASE

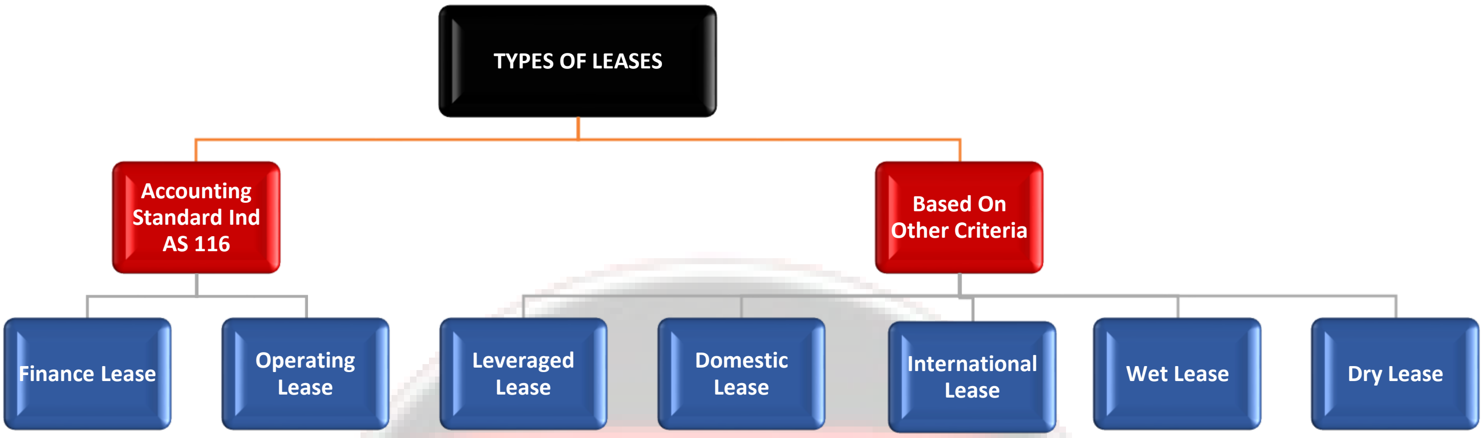
Lessor

The lessor is the party **who owns the property or asset being leased**. They are often referred to as the **landlord, owner, or leasing company**.

Lessee

The lessee is the party **who obtains the right to use the property** or asset from the lessor. They are often referred to as the **tenant or renter.**

TYPES OF LEASES



AS PER ACCOUNTING STANDARD IND AS 116

Finance Lease

A finance lease is a type of lease arrangement where the **lessee assumes** most of the **risks and rewards of ownership of the asset** during the lease term.

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

Ownership transfer

- The lease agreement contains a provision that **transfers ownership of the leased asset** to the **lessee by the end of the lease term** or upon fulfilling certain conditions.
- This means that the **lessee effectively becomes the owner** of the asset by the end of the lease.

Bargain purchase option

- The lease agreement **grants the lessee an option** to **purchase the leased asset at a price significantly below its fair market value**.
- This option is typically **exercised at the end of the lease term**, allowing the lessee to acquire ownership of the asset.

Lease term

- The **lease duration** covers **a substantial portion of the economic life** of the leased asset.
- If the lease term is **75% or more of the asset's estimated economic life,** it is considered a strong indicator that the lease is a finance lease.

Specialized Nature of the Asset

The leased asset is of a **specialized nature that only the lessee can use**, and it has **no alternative use to the lessor** at the end of the lease term.

Secondary Period at A Rent

The lessee has the option to extend the lease **for an additional period at a rent** that is considerably **lower than the prevailing market rate.**

Operating Lease

It is a type of **lease arrangement** where the l**essee obtains the right to use an asse**t from the lessor for a limited period **without taking on the risks and rewards of ownership**.

TYPES OF LEASES BASED ON OTHER CRITERIA

Leveraged Lease

- It is a lease arrangement where a **third-party lender provides a significant portion of the financing** for the leased asset.
- The lessor **borrows funds from the lender** to purchase the asset, while the lessee makes lease payments to the lessor.

- Leveraged leases involve three parties: the **lessor, lessee, and lender.**

Domestic Lease

It refers to a lease agreement that is specific to the **rental or leasing of property within the domestic or local market** of a particular country.

International Lease

- It refers to a **lease agreement** that involves the rental or leasing of property or assets **across international borders**.
- It occurs when the **lessor and lessee are located in different countries**, and the leased property is located outside the lessee's home country.

Sale And Lease Back Leasing

- It is a financial arrangement where an **asset owner sells the asset** to a buyer and **then immediately leases it back from the buyer**.
- In this transaction, the **asset owner becomes the lessee**, and the **buyer becomes the lessor**.

Wet Lease

In a wet lease, the **lessor is in charge of operating and maintaining the equipment** as well as its insurance and maintenance.

Dry Lease

In a dry **lease, the lessee is in charge of operating and maintaining the equipment** as well as its insurance and maintenance.

ADVANTAGES OF LEASING

- Preserved Borrowing Capacity
- Full Financing Availability
- Obsolescence Risk Mitigation
- Tax Benefits
- Flexible Covenants

LEASE AGREEMENT

- The lease agreement is a **written document outlining the terms and structure of the lease** between the lessor and lessee.
- This agreement serves as the framework **for all future activities that the lessor and lessee** take **in relation to the leased asset**.

CONTENTS OF A LEASE AGREEMENT

Parties it Identifies the **lessor and the lessee** including their legal names and contact information.

Lease Term It Specifies the **duration of the lease**, including the **start and end dates**, and may also include provisions for **renewal or extension.**

Description of the Asset It Provides a detailed description of the leased asset, including its **make, model, quantity, condition, and any specific features or specifications**.

Rent and Payment Terms It outlines the **agreed-upon rent amount**, frequency of payments, **due dates, and acceptable methods** of payment.

Maintenance and Repairs It provides **details of responsibilities of the lessor and the lessee** regarding maintenance, repairs, and upkeep of the leased asset.

Use and Restrictions It provides details about the **permitted uses of the leased asset** and any **prohibited or restricted activities** or modifications.

Termination and Renewal It Provides a detailed description of procedures and conditions for **early termination or surrender of the lease**, as well as any options for **renewal or extension**.

Default and Remedies It Outlines the consequences of default, such as **late payments or breach of contract**, and the **remedies available** to both parties in such situations.

GST ON LEASE TRANSACTIONS

- According to Section 7 of the CGST Act, 2017, the term "**supply" encompasses various forms of transactions** involving goods or services, **including lease arrangements**.
- GST **does not make a distinction between** different types of leases Whether it is a **finance lease or an operating lease**, both are considered taxable under the Goods and Services Tax (GST) regime.

INCOME TAX IMPLICATIONS OF LEASE

DEPRECIATION

- The lessor may be entitled to **claim depreciation on the leased asset** for income tax purposes.
- The **lessee**, on the other hand, generally **cannot claim depreciation** on the leased asset, as **they do not own it**

LEASE RENTALS

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

NOTE

The Income Tax rules treat finance leases and operating leases similarly without making any distinction between them.

ACCOUNTING IN THE BOOKS OF LESSOR

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

FOR FINANCE LEASES

- On the commencement date, the **lessor is obligated to acknowledge the assets** held under a **finance lease and include them on its balance sheet**.
- These assets should be **presented as a receivable**, at an amount equal to the net investment in the lease.

NET INVESTMENT IN THE LEASE

- The net investment in a lease represents the **present value of lease rentals expected to be received from the lessee**.
- To calculate this present value, the **interest rate implicit in the lease is used as the discount rate**.

EXAMPLE

Suppose a company owns a piece of equipment with a fair value of 50,000. The company enters into a finance lease agreement with a lessee. The lease agreement specifies lease payments of 10,000 per year for five years. The interest rate implicit in the lease is 10% p.a.

No. of years	Payments(X)	PVIF $1/(1+i)^n$ (Y)			P .V(X*Y)
1	10000	$\frac{1}{(1+0.10)^1}$	$\frac{1}{1.10}$	0.909	9090
2	10000	$\frac{1}{(1+0.10)^2}$	$\frac{1}{1.21}$	0.826	8260
3	10000	$\frac{1}{(1+0.10)^3}$	$\frac{1}{1.33}$	0.751	7510

4	10000	$\frac{1}{(1+0.10)^4}$	$\frac{1}{1.33}$	0.683	6830
5	10000	$\frac{1}{(1+0.10)^5}$	$\frac{1}{1.33}$	0.620	6200
Total	50000		PVIFA	3.789	37890

Explanation

Therefore, in the balance sheet of company an amount of 37890 will be shown as receivables from the lease asset.

FOR OPERATING LEASES

- The leased asset **remains on the lessor's balance sheet**, categorized **according to its nature and classification**.
- The lessor records a **lease receivable on its balance sheet,** representing the **amount due from the lessee over the lease term**.
- Any **initial direct costs** incurred by the lessor in negotiating and arranging the operating lease **are typically added to the carrying amount of the leased asset** and amortized over the lease term.

ACCOUNTING IN THE BOOKS OF LESSEE

Ind AS 116 has eliminated the differentiation between a finance lease and an operating lease in terms of accounting treatment in the books of the lessee.

RECOGNITION OF RIGHT-OF-USE ASSET

- Upon entering into a lease, the l**essee recognizes a right-of-use (ROU) asset on the balance sheet**.
- The ROU asset represents the **lessee's right to use the leased asset** throughout the lease term.

RECOGNITION OF LEASE LIABILITY

- The lessee also recognizes a **corresponding lease liability on the balance sheet**.
- The lease liability represents the l**essee's obligation to make lease payments over the lease term**.

The cost of the right-of-use asset in the books of the lessee under Ind AS 116 comprises the following components

Initial Measurement of Lease Liability

The lessee includes the **initial measurement of the lease liability**, which **represents the present value of lease payments, as part of the cost of the right-of-use asset**.

Initial Direct Costs

Any incremental **costs directly attributable to obtaining the lease**, such as **commissions or legal fee**s, are added to the cost of the right-of-use asset.

Lease Payments Made Before Commencement

If the lessee makes any **lease payments before the commencement of the lease term**, those payments are also **included in the cost of the right-of-use asset.**

Estimate of Dismantling, Removal, and Restoration Costs

An estimate of the **expenditures the lessee will incur to** remove the underlying asset, repair the site where it is located, or **bring the underlying asset** back into compliance with the lease's terms and conditions.

LEASING AS A FINANCIAL DECISION

It refers to the **choice made by businesses to acquire assets** through **lease agreements rather than purchasing them outright**. This decision is based on various factors

FACTORS AFFECTING LEASING DECISION

- Depreciation tax-shield
- Tax-shield on lease rentals
- Losing the scrap value at the useful life of the equipment

EXAMPLE

PARTICULARS	DETAILS
Cost of equipment	5000000
Useful life	5 years
Depreciation	Straight line method
Cost of borrowing	Post-tax interest rate of 12%
Lease rental	1800000
Tax rate	25%

SOLUTION

Particulars (Rs. Lakhs)	0	1	2	3	4	5
Cost of equipment	+50	-	-	-	-	-
Depreciation	-	10	10	10	10	10
Loss of depreciation tax-shield	-	-2.5	-2.5	-2.5	-2.5	-2.5

(Depreciation × 25%)						
lease payment	-	-18	-18	-18	-18	-18
Tax-shield on lease payment (Lease payment × 25%)	-	4.5	4.5	4.5	4.5	4.5
7. Cash flow effect of lease (1+3+4+5+6)	+50	-16	-16	-16	-16	-16

FINANCIAL DECISION

APPLYING NPV METHOD

To calculate the **Net Present Value (NPV) of the lease**, the **cash flows need to be discounted to their present value** using a discount rate of 10%. This discount rate represents the **post-tax borrowing rate**.

No. of years	Cash Flow(X)	PVIF $1/(1+i)^n$ (Y)			P .V(X*Y)
1	1600000	$\frac{1}{(1+0.10)^1}$	$\frac{1}{1.10}$	0.909	1454400

2	1600000	$\frac{1}{(1+0.10)^2}$	$\frac{1}{1.21}$	0.826	1321600
3	1600000	$\frac{1}{(1+0.10)^3}$	$\frac{1}{1.33}$	0.751	1201600
4	1600000	$\frac{1}{(1+0.10)^4}$	$\frac{1}{1.33}$	0.683	1092800
5	1600000	$\frac{1}{(1+0.10)^5}$	$\frac{1}{1.33}$	0.620	992000
Total	8000000		PVIFA	3.789	6062400

NPV = Sum of (Present Value of Cash Flow) - Initial Investment

NPV = 6062400 – 5000000 = 1062400

APPLYING EQUIVALENT LOAN AMOUNT METHOD

- Under the Equivalent Loan Amount method, **the cost of leasing is converted into an equivalent loan amount**.
- This is done by calculating the **present value of all lease payments using an appropriate discount rate**.
- The **resulting amount represents the loan amount** that would have the same cost as the leasing option.

No. of years	Cash Flow(X)	PVIF $1/(1+i)^n$ (Y)			P .V(X*Y)
1	1600000	$\frac{1}{(1+0.10)^1}$	$\frac{1}{1.10}$	0.909	1454400
2	1600000	$\frac{1}{(1+0.10)^2}$	$\frac{1}{1.21}$	0.826	1321600
3	1600000	$\frac{1}{(1+0.10)^3}$	$\frac{1}{1.33}$	0.751	1201600
4	1600000	$\frac{1}{(1+0.10)^4}$	$\frac{1}{1.33}$	0.683	1092800
5	1600000	$\frac{1}{(1+0.10)^5}$	$\frac{1}{1.33}$	0.620	992000
Total	8000000		PVIFA	3.789	6062400

Equivalent Loan Amount = 6062400

Explanation

As the equivalent loan amount is more than initial investment in the asset, it will be better for ABC Lid to buy the equipment, rather than lease it.

CASE STUDY ON LEASE FINANCE

A lease is a contractual arrangement where the lessor (owner) grants the lessee (user) the right to use an asset, such as real estate, equipment, or vehicles, for a specified period in exchange for regular payments. The lease agreement details the duration, payment terms, and conditions for the asset's use, maintenance, and return.

Q: 1 The lessor is the party who owns the property or asset being leased. They are often referred to as the landlord, owner, or leasing company. From the point of view of the lessor, a lease is considered a ___________.

a) Operational decision

b) Marketing decision

c) Investment decision

d) Purchase decision

Q: 2 The lessee is the party who obtains the right to use the property or asset from the lessor. They are often referred to as the tenant or renter. From the perspective of the lessee, a lease represents a __________.

a) Legal decision

b) Financing decision

c) Production decision

d) Strategic decision

Q: 3 The periodic payment made to use an asset under a lease agreement is referred to as __________.

a) Asset fee

b) Lease rental

c) Purchase cost

d) Maintenance charge

Q: 4 Which of these is advantage of leasing for lessee?

I. The borrowing capacity is not reduced

II. Availability of full finance

III. Avoiding risk of obsolescence

IV. Regular fixed income

V. Tax advantage

a) I, II,

b) II, III,

c) I, II, III, IV

d) I, II, III, V

Q: 1 Situations under which a lease is normally classified as a finance lease are___________.

I. The ownership of the asset is transferred to the lessee by the end of the lease term.

II. The lessee has the option to purchase the asset at a price which is substantially lower than the fair value.

III. The lease term is for a major part of the economic life of the asset

IV. Substantially transferring the risks and rewards of ownership of the asset to the lessee.

a) I, II,

b) II, III,

c) I, II, III

d) I, II,III, IV

Q: 2 Which of these is a feature of Leveraged lease?

I. Leveraged leasing involves a third-party lender providing a substantial portion of the financing for the leased asset.

II. The lessor secures funds from the lender to acquire the asset, and the lessee makes lease payments to the lessor

III. One portion of lease rental is passed on to the lender and one portion of lease rental portion is received by the lessor.

IV. All parties involved in lease transaction, are domiciled in India.

a) I, II,

b) II, III,

c) I, II, III

d) I, II, IV

Q: 3____________ is a financial arrangement where an asset owner sells the asset to a buyer and then immediately leases it back from the buyer. In this transaction, the asset owner becomes the lessee, and the buyer becomes the lessor.

a) Hire Purchase

b) Operating Lease

c) Sale and Leaseback

d) Lease Financing

Q:1 According to Section 7 of the CGST Act, 2017, the term "supply" encompasses various forms of transactions involving goods or services, including lease arrangements. GST make a distinction between different types of leases whether it is a finance lease or an operating lease and only finance lease considered taxable under the Goods and Services Tax (GST) regime. This statement True and False

a) True

b) False

c) Partially True

d) None of the above

Q:2 Income Tax rules do not differentiate between a Finance lease and an Operating Lease. Income Tax implications of a lease transaction are ____________.

a) Lessor is eligible for depreciation on the asset

b) The entire lease rentals are taxed as income of the lessor.

c) The lessee is entitled to treat the rentals as expenses.

d) All of the above

Q:3 Which of this statement is correct regarding prudential guidelines when bank undertake these activities departmentally?

I. Exposure ceilings with regard to single borrower 15% of the bank's capital funds and 20 % to infrastructure projects

II. For borrower group 40% of the bank's capital funds and 50% provided to infrastructure projects.

III. Total exposure of these activities should not exceed 10% of total advances.

a) I, II,

b) II, III,

c) I, II, III,

d) I, III