STUDENT NOTES

WHAT IS LEASE..?

A lease is–
An agreement, whereby,
- Lessor conveys to lessee the right to use an asset, for an agreed period of time,
- In return for a payment or a series of payments.

NON- APPLICABILITY

This standard does not apply to;
- Lease agreements to explore or use natural resources, such as oil, gas, timber, metals, other minerals: and
- Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents & copyrights; and
- Lease agreements for use of lands.
- Contracts for services that do not transfer the right to use asset from one contracting party to another.

TYPE OF LEASES

" lessor books : asset "

lessee → books: ownership → asset recorded
→ depn

↳ Right to use the asset → with lessee

FINANCE LEASE

A lease that transfers,
- Substantially all the risks & rewards, incidental to ownership of an asset

- The word to be focused on in the above definition is "substantially all".
- This is because, if all the risks & rewards are transferred then it becomes a transaction of outright sale & the question of lease does not arise.

OPERATING LEASE

An operating lease is a contract that permits the use of an asset without transferring the ownership rights of said asset.

- Operating leases provide greater flexibility to companies as they can replace/update their equipment more often
- No risk of obsolescence, as there is no transfer of ownership

CA Tejas Suchak

Lenovo → "Lease" → Deloite

Laptops

↓

Legal owner
Lessor

"Lease"
↓
1000 laptops
UL = 5years

Deloite
↓
Effective owner
Lessee

→ "Finance Lease"

"Agreement" → "Indicators of Finance lease"

→ 4 years ka agreement. → 80% productivity
→ Deloite : 1000 laptops → use
→ associated firms further rent out

} 4 saal ke rewards

→ Laptop :- repair → Deloite ka kharcha
damage → Deloite ka kharcha
theft → Deloite ka kharcha

} 4 saal ke risks

Substantially all Risk & Reward → Deloite ← effective owner
↓
Almost

not the legal owner

Finance Lease :-

1. Right to use the asset.
2. Substantially all risks & rewards related to the ownership of that asset vest with the lessee.

↓

In case of finance lease the asset taken on lease will be recorded in the books of lessee. This is based on the concept of substance over form (AS-1) which states that transactions are recorded on the basis of their actual substance rather than the legal form.

Indicators

① "4 years agr." → Lessee : ownership → Lease Term → Finance lease

Lessor: cost = 1cr.

0 — 2years

Lease Term — ownership = Lessee

⇒ Lease Rent = 1.2crores

Agr
2 years
LT : Lease Rent : Total 1.2cr.
After 2 years
lease agr end & own hand.

L31

(2) Cost = 1cr. "UL = 5years"

Y0 — Y2

Y0
LT
comm.
inception

Y2
option with lessee to purchase the asset
fair value = 75 lakhs
purch price = 20 lakhs

"Agreement"

lease Rent = 1.25cr.

reasonably certain that option to purchase will be exercised.

4. Y0 — Y1 — Y2 — Y3

	Y0	Y1	Y2	Y3
		LR	LR	LR
	C = 1cr.	30L	50L	50L
	FV = 1cr.			

PV = 25L
PV = 40L
PV = 30L
95L

"Finance lease"

STUDENT NOTES

RISKS:
- ➢ Possibility of losses from:
- ➢ Idle capacity.
- ➢ Technological obsolescence.
- ➢ Changes in economic conditions.

❖ Operating lease are treated as expenses (i.e. off balance sheet items) whereas a finance lease is included as an asset for the lessee

REWARDS:
- ➢ Expectation of Profitable operation over the economic life of the asset.
- ➢ Gain from appreciation in value or realisation of residual value

❖ All rewards and Risk during the lease terms belong to lessor such as any appreciation , any gain arise from the asset, any maintenance & repairing cost etc.

Think of a capital lease as more like owning a piece of property

Think of an operating lease as more like renting a property.

INDICATORS OF FINANCE LEASE
(APPLY THE TEST OF SUBSTANCE OVER FORM)

1) If Lessor transfers ownership of asset to lessee by the end of the lease term, then Finance Lease.

2) If the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the Fair value of the asset at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised, then Finance Lease.

3) If Lease Term is for a major part of economic life of the asset, then Finance Lease. Major part simply doesn't mean more than 50%, it means substantially the whole life of the asset.

Yo ✓ lease Rent = 95L

4) At the inception of the lease, if the PV of minimum lease payments amounts to at least substantially whole of the fair value of the asset, then FL.

100

5) If the leased asset is of specialised nature such that only the lessee can use it without major modifications being made, then Finance Lease.

6) If the lessee can cancel the lease & losses accruing to lessor on cancellation are borne by the lessee, then Finance Lease.

7) If gains/losses from fluctuation to residual value accrue to the lessee, then Finance Lease.