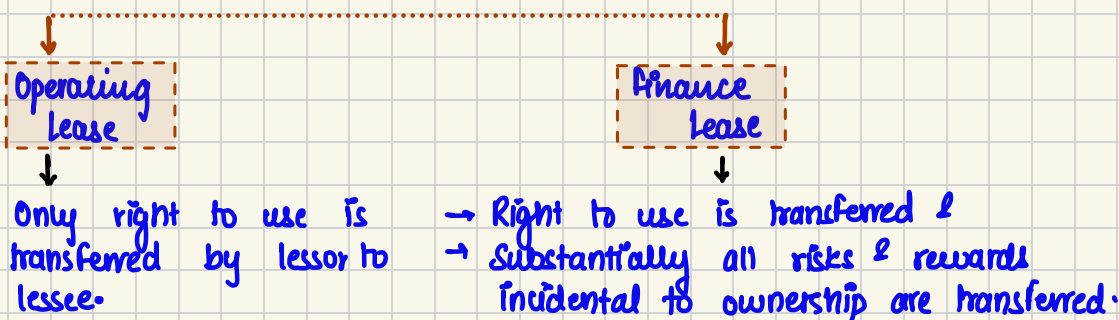


Lease :- Lessor conveys to the lessee :-

- the right to use the asset
- in exchange :- a payment series of payments.

Leases can be of two types :-



Indicators of Finance Lease

- 1) Lessor transfer the ownership to lessee at the end of lease term.
- 2) Lessor gives the lessee the right to purchase the asset at the end of lease term at a price which is substantially lower than the fair market value, such that at the inception of lease it becomes reasonably certain that the lessee will exercise the option.
- 3) Lease Term is for the major part of economic life of asset.
- 4) PV of MLP is approximately equal to fair value at the inception.
- 5) The asset is of such specialised nature that only the lessee can use it without major modifications being made.
- 6) If on cancellation of lease, the losses accruing to lessor are borne by lessee.
- 7) Fluctuations to Residual Value → Gain/Loss → accruing to lessee.
- 8) Lease rent for secondary term is substantially lower.

Accounting for Finance Lease

Lessee Books

Assets :- Leased Asset + Initial Direct cost
Expense :- Depreciation, Interest (Finance Ch.)
Liability :- Lease Rental payable

Lessee will record the asset in NBs books at lower of :-

- 1) Present Value of MLP
- 2) Fair Value.

Lessor Books

Asset :- Lease Rent receivable.
Income :- Interest Income
Initial Direct cost will be charged to P&L.

Important Terminologies for practical questions

Minimum Lease Payment

Lessee POV

- Lease Rentals
- Guaranteed residual value : by lessee : on behalf of lessee

Lessor POV

- Lease Rentals
- Guaranteed residual value : by lessee : on behalf of lessee : by independent third party.

* contingent rent is not included in MLP.

+ Unguaranteed Residual Value

= Gross Investment in Lease (MLP + UGRV)

- Interest Unearned finance income

= Net Investment in Lease (PV of MLP + PV of UGRV)

Accounting for operating lease

Lessee Books

Asset :- x
Expense :- Lease Rentals + Initial Direct cost
Liability :- Lease Rental pay.

Lessor Books

Asset :- Leased Asset + IDC
Expense :- Depreciation
Income :- Lease Rental

Sale & Leaseback Transactions

Finance Lease

- Profit/Loss on sale will be deferred and amortised over the lease term.

Operating Lease

THUMB RULE

- Compare CA with FV.
- Compare RCA with SP.

Sale & Leaseback : Operating Lease

(imp. points)

- 1) IF $CA > FV$: recognise loss immediately & bring down CA to FV.
IF $CA < FV$: no treatment required.

We will arrive at RCA.

- 2) $RCA < SP$: Profit

$SP > FV$

Profit will be deferred & amortised over lease term.

$SP = FV$

Profit will be recognised immediately.

$RCA > SP$: Loss

$SP < FV$

Loss is compensated by future lower lease rentals

Defer and amortise over lease term.

Loss does not have an impact on future lease rentals.

Recognise loss immediately.

Recognise loss immediately