A STUDY OF ACCOUNTING AND REPORTING OF CAPITAL AND OPERATING LEASE

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Abstract: Leaseaccountingis an important concept in the accounting. The type of lease accounting differs based on the end user. A lessee and a lessor report and account teases differently. A lessor is the owner of the asset and a lessee uses the leased asset by paying periodically to the lessor. The accounting and reporting of the lease in different ways has varying effects on financial statements and ratios. The current paper discusses the types of the lease accounting and accounting and reporting by lessor and lessee in the case of different types of leases.

Key words: Lease accounting, financial lease, capital lease, operating lease.

1. Introduction

Lease is a contract where the property owner gives permission to another party to use the property in exchange of money or any other assets. There are two types of leases in accounting field. They are operating lease and financing lease.

2. Objectives

- To define lease accounting and its types
- To discuss the capital and operating lease with examples
- To discuss the accounting and reporting by lessee
- To discuss the accounting and reporting by lessor

3. Lease Accounting

A lease is an arrangement under which a lessor agrees to allow a lessee to control the use of identified property, plant, and equipment for a stated period of time in exchange for one or more payments. There are several types of lease designations, which differ if an entity is the lessee or the lessor. The choices for a lessee are that a lease can be designated as either a finance lease or an operating lease.

3.1 Finance Lease: Finance lease is the one in which all risks and rewards of the property are transferred to the owner of the property. The title may or may not be transferred eventually. Finance lease is also called as capital lease.

Few examples of the finance lease are:

- Assets will be transferred to the lessee at the end of the lease term.
- Lessee has the option to purchase the leased assets from the lessor at the lower price than the fair price on the date when the option becomes exercisable.
- Lease term covers complete economic life of the asset even if title is not transferred
- Leased asset is of a specialized nature.

In the case of financial lease, the lessee will have an option to purchase the asset at a future date or at the end of the contract period. This option will be provisioned at the beginning of the lease period itself. The validity of the lease will be for a significant portion of the useful economic life of the asset, generally in the range of 75% or more.

The net present value(NPV) of minimum lease payments will be atleast 90% of the asset's actual value.

3.2 Operating Lease: Any lease that does not fall under finance lease is called as an operating lease. This is basically a contract between landlord and the tenant. The risks and rewards are not fully transferred in case of operating lease. Operating leases provide the lessee the right to use the asset without ownership rights. Operating leases are considered a form of off-balance-sheet financing—meaning a leased asset and associated liabilities (i.e. future rent payments) are not included on a company's balance sheet. When a lessee has designated a lease as an operating lease, the lessee should recognize the following over the term of the lease:

- A lease cost in each period, where the total cost of the lease is allocated over the lease term on a straight-line basis.
- Any variable lease payments that are not included in the lease liability
- Any impairment of the right-of-use asset

3.3 **The advantages of leasing**

- Leasing has lots of benefits than loan contracts which can attract customers:
- Payment schedules are very much flexible in leasing compared to loan contracts.
- Costs after tax are lower in leasing as the tax rates differs in both the cases.
- Entire amount or 100% financing is possible in leasing whereas in the case of loans it is not possible.
- In the case of operating lease, an expense will be created instead of a liability allowing the company to obtain the financial funding. It is also called as off-balance sheet financing.

3.4 Disadvantages of leasing

In the lease accounting, the entire rights on the assets will be transferred to the lessee for a specific period of time mentioned in the lease agreement. The lessee may not take care of the assets as much as the lessor takes care. This difference in the caring of the property is called as agency cost. The ownership and the control over the asset will be different for lessee and lessor.

4. Financial Lease example

On January 1, 2015, ABC Company signed a 5-year lease agreement for equipment. Annual payments are Rs.28.5Lakh, to be made at the beginning of each year. At the end of the lease, the equipment will revert to the lessor. The equipment has a useful life of 5 years and has no residual value. At the time of the lease agreement, the equipment has a fair value of Rs.166 Lakh. An interest rate of 10.5% and straight-line depreciation are used.

- There is no bargain purchase option because the equipment will revert back to the lessor.
- The life of the lease is 5 years and the economic life of the asset is 5 years. This is 100%.
- Using a financial calculator, calculate for the PV of the minimum lease payments:
    - N = 5
    - I/YR = 10.5
    - FV = 0
    - PMT = 28,50,000
    - PV = 164,99,500
    - Therefore, 164,99,500/166,00,000 = 99%

This is a financing/capital lease because at least one of the finance lease criteria is met and during the lease, the risks and rewards of the asset have been fully transferred.

5. Operating LeaseExample

Accounting for operating leases is straightforward because they do not involve recognition of any asset or liability. The lease income is recognized on a basis reflecting the use of the asset.

Accounting for Lessor

No journal entry shall be made the start of the lease contract.

During the first year, the lessor shall recognize receipt of lease rental as follows:

Cash	Rs.500,000	
Lease rental income		Rs.500,000

Accounting for Lessee

No journal entry shall be made at the start of the lease.

At the time of first payment, the following journal entry is required:

Lease expense	Rs500,000	
Cash		Rs.500,000

6. 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:

6.1 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:** 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 expense is also reported as with any other asset.
- **Cash Flow Statement:** Under U.S.GAAP, the interest component of the 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.

6.2 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.

6.3 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 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.

6.4 Impact Of Lease Accounting On Lessee's Financial Ratios

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

- Current ratio, working capital, asset turnover ratio, fixed asset turnover ratio, return on assets in early years and return on equity 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 is higher in finance lease.

7. Accounting and Reporting by Lessor

7.1 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.

7.2 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.

7.3 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 is 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 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.

8. Conclusion

The accounting and reporting of a lease differ from the perspective of a lessor and a 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.

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