

CHAPTER 8

LEASING! AN ATTRACTIVE OPTION FOR FINANCING CAPITAL INVESTMENTS

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52 BOOKS OF ACCOUNTS – A QUICK RECAP

In Chapter 3, we talked about the Books of Accounts which are normally used by a Business. Of these, the following Books of Accounts are used for Accounting of Leases:

- General ledger.
- Cash & Bank Book.

In this chapter, wherever Accounting entries are required to be shown, we will use these Books of Accounts for illustration purposes.

53 WHAT IS LEASE?

In simple words, Lease is the use of an asset for a certain pre-agreed time period against periodic payments.

Lease is a contract under which an asset owned by one person is handed over to another person to be used in that another person's Business against periodic payments of rentals to the first person. In leases, ownership may or may not transfer to the person who makes rental payments and depends on the terms of the Lease agreement signed between the two parties.

In most common situations, Lease arrangements are in respect of Fixed Assets. However, Leases may also be executed against current assets, e.g. inventory items – the important thing to remember here is that there needs to be a tangible asset which can be leased.

54 COMMONLY USED TERMS

Before we discuss Leases in more detail, it may be useful to understand some of the commonly used terms when Leases are discussed.

Lessor	Lessor is the person who provides an asset to another person for use and receives periodic payments in return.
Lessee	Lessee is the person who takes an asset from another person, for own use & consumption, and pay periodic payments in return.
Lease key money (or down payment)	It is the sum of money that is paid as an advance in a Lease.
Lease term	It is the number of months or years for which a Lease agreement has been executed between two parties.
Salvage value (or residual value)	This is an estimate of the market value of a Leased asset at the end of the lease term.

55 TYPES OF LEASES

Typically, all leases are classified as either Operating Leases or as Finance Leases. Deciding whether a Lease is classified as an Operating or as a Finance Lease depends on the wording of the Lease agreement.

We will now briefly discuss some of the features of the two types of Leases:

55.1 FINANCE LEASE

In a Finance Lease, the ownership of leased asset stays with the lessor until all payments have been made. During this time, the physical possession and use of the asset is with the lessee.

Accounting rules have laid down certain “tests” to determine whether a lease shall be classified as a Finance Lease or not:

- All repair, maintenance, insurance and general upkeep of the asset should be the responsibility of the lessee.
- Lease term should be for a period so that the lessee has had the benefit of substantially utilizing the useful life of the asset.
- The lessee should have the option to purchase the asset from the lessor on concessional terms at the expiry of the lease term.

55.2 OPERATING LEASE

An Operating Lease, by process of elimination, is therefore a lease which is not a Finance Lease. What this means, in case of an Operating Lease, is that:

- All repair and maintenance on that leased asset shall be lessor's responsibility.
- The lease term should not extend to a substantial part of the useful economic life of the leased asset.
- There should be no option for the lessee to acquire the asset.

From an Accounting viewpoint, a Finance Lease is one in which the leased asset and amounts payable to the Leasing Company are shown as "Asset" and "Liability", respectively in the lessee's Books of Accounts. On the other hand, in case of Operating Leases, only rental paid are shown as an "Expense".

56 WHY SHOULD A BUSINESS LEASE?

Leasing is an alternative with which a Business can get its fixed assets financed. A few of the commonly given reasons for using Leasing are mentioned below:

56.1 BANK FINANCING MAY NOT BE AVAILABLE

Commercial Banks have stringent criteria for extending financing which are perhaps even more stringent in the case of Businesses classified as SMEs. In such circumstances, it may be difficult to negotiate long term financing with Banks for purchase of machinery, equipment and other fixed assets. Leasing, in such cases, is a good alternate.

56.2 SMALL UPFRONT CASH INVESTMENT

Leasing companies normally ask for a small down payment, anything between 10% - 30%, which means that not a very large chunk of a Business's cash capital gets blocked as investment in fixed assets.

However, please be aware that a small down payment means a large financed amount which means higher installments – on the other hand, a larger down payment results in smaller installments!

Deciding what down payment to choose really depends on how much a Business can afford to repay by way of installments.

56.3 REPAYMENTS SPREAD OVER AFFORDABLE TENURE

Leases offer multiple options with tenures varying between one to five years. Businesses normally have the option to choose a tenure which suits their ability to repay the leased amount comfortably.

Businesses normally have the option to choose a repayment plan; monthly or quarterly

or annual, as well as choose whether the repayments shall be higher or lower in the initial period(s).

Leasing companies, however, normally carry a higher mark up as compared to Commercial Banks!

56.4 TAX ADVANTAGE

Leasing normally gives tax advantages to both Lessee and Lessor depending on how the Lease Agreement has been drawn up. Tax implications of leases shall be covered in Chapter 16.

57 HOW ARE LEASES RECORDED?

Accounting treatment for lease varies depending on whether it is a Finance Lease or an Operating Lease. Also, the accounting treatment is different if we are making the accounts of a Lessor or a Lessee. In the following sections, we will show the recording of Leases in a lessee's Books only.

57.1 OPERATING LEASE

Accounting entries for an Operating Lease are very simple. Each periodic payment under an Operating Lease is charged as an expense for the Business, and this continues till the end of the lease term.

EXAMPLE # 8.1

Operating Lease

On 10/5/06, Hussain Khaddar & Looms (Pvt) Ltd signed a lease agreement for a godown near the factory premises with a Mr. Asim (the lessor). It was agreed that the lessee would pay Rs. 20,000 as monthly rent and give Rs 100,000 as security. The lease agreement was signed for a period of 10 months, i.e. 1/5/06 to 28/2/07. The company paid rent for the month of May on 1/5/06 and for June on 13/6/06.

Making payment for Security Advance:

GENERAL LEDGER							
SECURITY ADVANCE ACCOUNT				GL-18			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/5/06	GL-20	Cash Account	100,000				

CASH & BANK BOOK							
CASH ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/5/06	GL-18	Security Advance Account	100,000

2) Making payments of two months lease rental:

GENERAL LEDGER							
RENT ACCOUNT							GL-26
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/5/06	GL-20	Cash Account	20,000				
13/6/06	GL-20	Cash Account	20,000				

CASH & BANK BOOK							
CASH ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/5/06	GL-26	Rent Account	20,000
				13/6/06	GL-26	Rent Account	20,000

57.2 FINANCE LEASE

As we explained in section 4.1 above, Finance leases are similar to a Business taking on financing to purchase assets. In such a case, the recording of lease is a combination of making an entry for:

- Purchase of a fixed asset; AND
- Financing from a leasing company.

EXAMPLE # 8.2

Finance Lease

Hussain Khaddar & Looms acquired a delivery van on finance lease on 1/5/06. Total tenure of the lease was 4 years with a monthly rental of Rs. 20,350. Down payment was paid on 1/5/06 and the first rental will be paid on 30/5/06 and monthly thereafter on each month's end. Depreciation is charged over a period of 4 years on a straight line basis, and full year's depreciation is charged in the year of purchase.

1) Acquiring the delivery van on finance lease:

GENERAL LEDGER							
LEASED ASSET ACCOUNT – DELIVERY VAN				GL-19			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/5/06	GL-23	Payable to Leasing Company Account -Delivery Van	900,000				

GENERAL LEDGER							
PAYABLE TO LEASING COMPANY ACCOUNT – DELIVERY VAN				GL-23			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/5/06	GL-19	Leased Asset Account– Delivery Van	900,000

2) Making the down payment:

GENERAL LEDGER							
SECURITY DEPOSIT ACCOUNT – DELIVERY VAN				GL-35			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/5/06	GL-20	Bank Account	90,000				

CASH & BANK BOOK							
BANK ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/5/06	GL-35	Security Deposit Account – Delivery Van	90,000

Payment on two months rental to the leasing company: at the inception of a Finance Lease, the leasing company will give a Schedule which will show the monthly lease installments to be paid. A typical lease schedule is shown below:

LEASE SCHEDULE

Prime Cost	<u>900,000.00</u>
Downpayment 10%	<u>90,000.00</u>
Lease Amount	<u>810,000.00</u>
Markup Rate	9.5%
No of Installments	48
Rentals	Rs. 20,349.74

Due Date	Initial Balance	Rental	Markup	Principal Payment	Ending Balance
30-May	810,000	20,350	6,413	13,937	796,063
30-Jun	796,063	20,350	6,302	14,048	782,015
30-Jul	782,015	20,350	6,191	14,159	767,856
30-Aug	767,856	20,350	6,079	14,271	753,586
30-Sep	753,586	20,350	5,966	14,384	739,202
30-Oct	739,202	20,350	5,852	14,498	724,704
30-Nov	724,704	20,350	5,737	14,613	710,091
30-Dec	710,091	20,350	5,622	14,728	695,363
30-Jan	695,363	20,350	5,505	14,845	680,518
28-Feb	680,518	20,350	5,387	14,962	665,556
30-Mar	665,556	20,350	5,269	15,081	650,475
30-Apr	650,475	20,350	5,150	15,200	635,275
30-May	635,275	20,350	5,029	15,320	619,955
30-Jun	619,955	20,350	4,908	15,442	604,513
Total		<u>284,896</u>	<u>79,409</u>	<u>205,487</u>	

You will note that a portion of each monthly lease installment includes mark up and a portion of the same contributes towards repayment of the amount outstanding under the finance lease.

Accounting entry for the lease installment for May '06 & June '06 will be as follows:

GENERAL LEDGER							
INTEREST EXPENSE ACCOUNT				GL-36			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/5/06	GL-20	Bank Account	6,413				
30/6/06	GL-20	Bank Account	6,302				

GENERAL LEDGER							
PAYABLE TO LEASING COMPANY ACCOUNT – DELIVERY VAN				GL-23			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/5/06	GL-20	Bank Account	13,937				
30/6/06	GL-20	Bank Account	14,048				

CASH & BANK BOOK							
BANK ACCOUNT				GL-20			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/5/06	GL-36	Interest Expense Account	6,413
				30/5/06	GL-23	Payable to Leasing Co – Delivery van Account	13,937
				30/6/06	GL-36	Interest Expense Account	6,302
				30/6/06	GL-23	Payable to Leasing Co – Delivery van Account	14,048

3) Depreciation expense is recorded:

Since the asset has been recorded as a fixed asset, as we have covered in Chapter 7, all fixed assets will be depreciated. Except that, in the case of assets acquired through finance leases, the word "depreciation" is replaced by "amortization". The entries will be as follows:

GENERAL LEDGER							
AMORTIZATION ACCOUNT				GL-29			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/6/06	GL-30	Provision for Amortization Account	225,000				

GENERAL LEDGER							
PROVISION FOR AMORTIZATION ACCOUNT				GL-30			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/6/06	GL-29	Amortization Account	225,000

57.3 FINANCE LEASES VS. OPERATING LEASES

The following table summarizes the key differences between the two types of leases:

Operating Lease	Finance Lease
1 Assets are not recorded.	Assets are recorded.
2 Depreciation is not charged.	Depreciation is charged as an expense.
3 Lease rentals are charged as expense.	Only mark up is charged as an expense.
4 No liability for finance lease is shown.	Liability for repayment of finance lease is shown.

Remember, finance leases are like bank financing – therefore, the Accounting treatment of finance leases and bank financing is similar, which is shown in the table below:

Finance Lease	Bank Financing
1 Assets are recorded as fixed assets.	Assets are recorded as fixed assets.
2 Amortization is charged as an expense.	Depreciation is charged as an expense.
3 Financial charges are expensed.	Financial charges are expensed.
4 Installment includes principal repayment..	Installment includes principal repayment.

However, from a taxation point of view, there are differences between the two types of financing which are explained in the table below:

Finance Lease	Bank Financing
1 Tax depreciation as an expense is not available.	Tax depreciation is available.
2 Financial costs do not reduce taxable profits.	Financial costs reduce taxable profits.
3 Full installment (including the principal repayment) amount reduces the taxable profits.	Principal repayment amount does not reduce taxable profits.

58 USING LEASING TO YOUR ADVANTAGE!

58.1 MARK UP RATE VS. TENURE

If the monthly installments are sensitized to both the interest rates and the tenure of financing, Businesses will find that the monthly installment is considerably smaller if the tenure of financing is increased as compared to a decrease in the mark up rate.

Admittedly, if the tenure is extended, a Business will end up paying more mark up – however, in the early days of a Business, when profits and cash flows are increasing gradually, extending the tenure will enable a Business to reduce the amount of its monthly installment by a much larger amount than if the tenure was shorter. The example on next page will further illustrate this view point.

EXAMPLE # 8.4

COMPARATIVE LEASE SCHEDULE			
(Amounts in PKR)		Schedule A	Schedule B
A Prime Cost		<u>900,000.00</u>	<u>900,000.00</u>
B Downpayment 10%		<u>90,000.00</u>	<u>90,000.00</u>
C Lease Obligation		<u>810,000.00</u>	<u>810,000.00</u>
D Markup Rate		9.0%	10.0%
E No of Installments		12	12
F Monthly Rentals		70,835.70	71,211.87
G Total Rentals	E*F	850,028.35	854,542.42
H Total Interest	G-C	40,028.35	44,542.42

Comparing Schedule A and Schedule B, we can see that a 1% increase in mark up rate increases the monthly installment by only Rs. 376.17 while the total mark up increases by Rs. 4,514.07 only.

EXAMPLE # 8.5

COMPARATIVE LEASE SCHEDULE			
(Amounts in PKR)		Schedule A	Schedule C
A Prime Cost		<u>900,000.00</u>	<u>900,000.00</u>
B Downpayment 10%		<u>90,000.00</u>	<u>90,000.00</u>
C Lease Obligation		<u>810,000.00</u>	<u>810,000.00</u>
D Markup Rate		9.0%	9.0%
E No of Installments		12	24
F Monthly Rentals		70,835.70	37,004.64
G Total Rentals	E*F	850,028.35	888,111.39
H Total Interest	G-C	40,028.35	78,111.39

In Schedule A and Schedule C, we can see that by keeping the mark up rate same but by increasing the tenure by 1 year, the monthly installment reduces by almost half. However, the benefit of lower monthly installment comes with almost doubling of mark up over the lease term.

58.2 LEASE VS. BUY

Where a Business has sufficient profits, it will normally be more advantageous for Businesses to enter into a Finance Lease arrangement rather than taking bank financing. In case of Finance Leases, for the purposes of calculating tax liability, the total monthly installment becomes a deductible expense even though, in the Books of Accounts a portion of the monthly installment also includes a portion of the principal amount.

To see whether a finance lease is more beneficial or bank financing, please consult your tax advisor.

CHAPTER HIGHLIGHTS

What have we covered?

1. Leasing is one of the many methods of financing providing easy and flexible financial terms.
2. Leasing is classified either as operating and finance lease.
3. In a Finance Lease, amongst other criteria, ownership is very likely to get transferred at the end of the lease term.
4. Operating lease is the one in which the ownership of the asset is not transferred.
5. Tax advantages are normally associated with leases.
6. In operating leases, monthly installments are treated as normal business expense.
7. In finance leases, monthly installments are made up of mark up cost and principal repayments.
8. Extending the tenure of financing will result in considerably reduced monthly installment as against mark up rate.
9. Decision to buy (through bank financing) or lease an asset should be made each time that capital investment is planned.

