Leasing

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the similarities and differences between capital leases and operating leases. Specifically, this lesson will cover:

1. Capital Lease vs. Operating Lease

A **capital lease**, also called a financial lease, is a commercial financial agreement. The lessee, such as a company, will select an asset, like a piece of equipment that they need. The finance company, or the lessor, will buy that asset. The company will then use that asset over its life. In the end, the finance company will recover a large part of the cost of the assets plus any interest they have charged on all the rentals paid by the company. The company may have the option to purchase the asset at an agreed upon purchase price.

Operating lease is a lease of a much shorter term, compared to the capital lease, in the full useful life of the asset being purchased. Operating leases are commonly used to acquire equipment for a relatively short-term basis.

> EXAMPLE An aircraft, which has an economic life of 25 years, might be leased to an airline for five years on an operating lease. This is done by the lessor.

This is a good way for the company to outsource industrial equipment. It does not require the company to use equity. At the end of an operating lease, the asset does not pass to the lessee, or the company.

At the end of the operating lease, the equipment is typically returned, or the lease is renewed.

TERMS TO KNOW

Capital Lease

A lease that is usually quite long, perhaps even the entire duration of the life of the asset being leased; it has balance sheet implications, as the asset itself may be transferred at the end of the contract.

Operating Lease

A lease that is usually short compared to the life of the asset being leased, and does not result in a change of ownership at the end of the lease.

2. Accounting Impacts

Leasing will have a significant impact on financial statements during the accounting process in the leasing period.

Accounting Impacts	
Operating Lease	**Capital Lease**
Not reported as an asset or liability, so it doesn't appear on the balance sheet	Reported on the balance sheet as both an asset and a liability
Does appear on the income statement as payments are incurred	Appears as an asset as the present value of the rental payments made on the cumulative basis to date
Usually appears as rent	Appears as a liability as an element of long-term debt

3. Lease Criteria

Sometimes it is not clear whether a lease is a capital lease or an operating lease.

The lease is considered to be a capital lease if it meets any of these conditions:

- The company gains ownership of the asset at the conclusion of the lease
- The company is offered a bargain purchase contract at the end of the lease, paying less than market value
- The life of the lease is equal to or greater than 75% of the estimated life of the asset
- The present value of the minimum lease payments is equal or greater to 90% of the market value of the leased property

If any of these criteria are met, then the lease is considered a capital lease and it will impact the assets and liabilities of the balance sheet. Otherwise, it is seen as an expense and is filed as an operating lease on the income statement.

4. Advantages of Leasing

Leasing is less capital intensive than purchasing. If a business has constraints on its capital, it could grow more rapidly by leasing property than by purchasing that same property.

Capital assets may also fluctuate in value, so leasing shifts the risks to the lessor, or the financing company. However, if the market for that equipment has shown steady growth over a long period of time, the business could be sacrificing capital gains.

Depreciation of capital assets has different tax and financial treatment from ordinary business expenses. Lease payments can be considered expenses rather than assets, which can be offset against revenue when calculating taxable profit at the end of the accounting period.

In some cases, leasing may be the only practical option.

> EXAMPLE A small business may wish to open a location in a large office building with tight location parameters.

Finally, leasing may provide more flexibility to a business that expects to grow or move in a relatively short term because a lessee is not usually obliged to renew a lease at the end of its term.

SUMMARY

In this lesson, you learned that leasing is another method for companies to achieve long-term capital investment. A **capital lease**, or financial lease, has a financing company purchasing an asset required by a business. The business makes payments for the full economic life of the equipment. An **operating lease** is a lease whose term is shorter compared to the economic life of a piece of equipment. At the end of an operating lease, the title does not pass to the lessee, but remains with the lessor, the financing company.

Accounting impacts and **leasing criteria** are different for these two types of leases. A capital lease is reflected as both an asset and a liability on the balance sheet, based on the present value of lease payments made to date. An operating lease has its payments shown as an expense in the accounting period in which they are made.

Advantages of leasing include being less capital intensive than purchasing, the deferral of value fluctuation from the company to the lessor, potential favorable tax impacts from operating leases whose payments are shown as expenses, and being a flexible source of financing for small business, as they may expect to grow and move in the relatively short term.

Best of luck in your learning!

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