Finance lease

From Wikipedia, the free encyclopedia

A **finance lease** or **capital lease** is a type of lease - the other being an operating lease. A finance lease effectively allows a firm to finance the purchase of an asset, even if, strictly speaking, the firm never acquires the asset. Typically, a finance lease will give the lessee control over an asset for a large proportion of the asset's useful life, providing them the benefits (and risks) of ownership.

Contents

Treatment in the United States

Under US accounting standards, a finance lease is a lease which meets at least one of the following criteria:

- the lease term is greater than 75% of the asset's estimated useful life
- the lease contains a bargain purchase option to buy the equipment less than fair market value.
- ownership of the asset is transferred to the lessee at the end of the lease term
- the present value of the lease payments exceeds 90% of the total original cost of the equipment.

Following GAAP accounting point of view, such a lease is classified as a *purchase by the lessee* and is capitalized on the lessee's balance sheet. See FASB-13 for definitions between capital and operating leases.

Special Case: Finance Leases under UCC Article 2A

The term sometimes means a special case of lease defined by Article 2A of the Uniform Commercial Code (specifically, Sec. 2A-103(1) (g)). Such a finance lease recognizes that some lessors are financial institutions or other business organizations that lease the goods in question purely as a financial accommodation and do not want to have the warranty and other entanglements that are usually associated with leases by companies that are manufacturers or merchants of such goods. Under a UCC 2A finance lease, the lessee pays the payments to the lessor (and indeed must do so, regardless of any defect in the leased goods – this obligation usually being contained in a “hell or high water” clause), but any claims related to defects in the leased goods may be brought only against the actual supplier of the goods. UCC 2A finance leases are usually easy to identify because they commonly contain a clause specifically declaring that the lease is to be considered a finance lease under UCC 2A.

Treatment in Australia

In Australia the accounting standard pertaining to lease is AASB 117 'Leases'. AASB 117 was released in July 2004. AASB 117 'Leases' applies to accounting for leases other than: (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and (b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

According to AASB 117, paragraph 4, a lease is: an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A lease is classified as a finance lease if it "transfers substantially all the risks and rewards incidental to ownership of an asset." (AASB 117, p8) There are no strict guidelines as to what constitutes a finance lease, however guidelines are provided within the standard.

External links

- Definition of capital lease (http://www.investorwords.com/722/capital_lease.html)
- AASB 117 (http://www.aasb.com.au/public_docs/aasb_standards_2005/compilations/AASB117_07-04_COMPfeb07_02-07.pdf)

References

- Australian Financial Accounting, 4th edition, Craig Deegan ISBN 007471479-1

Categories: Finance terms | Business law