Finance Lease: Key Differences, Accounting and Tax Treatment

A finance lease is defined as a legal paper lease that enables the lessee to use an asset for quite a long time, almost equal to its useful life, and pay agreed fixed payments, thus giving the lessee an option to acquire the asset at the lease's end. Finance leases are the best options through which businesses acquire possession of expensive holdings without making an upfront purchase. The company could take a finance lease, and all risks and rewards of ownership would be transferred to the lessee.

What is Finance Lease?

Lease accounting is handled in IFRS 16 by considering each entity while recognizing assets and liabilities associated with leases entered into. Finance leasing accounts are recorded with finance lease amortization and finance lease depreciation.

Finance Lease Journal Entries

The finance lease gets recorded in a company through journal entries. At lease inception, the lessee recognizes the lease component in terms of both the asset and liability related to it:

Journal Entry at Lease Inception:

Debit: Right-of-Use Asset (ROU)

Credit: Lease Liability

Each month, the lessee records the depreciation and amortization at the time of calculating the finance lease interest:

The Journal Entry for Depreciation:

Debit: Depreciation Expense

Credit: Accumulated Depreciation

Journal Entry for Interest Expense:

Debit: Interest Expense

Credit: Lease Liability

Finance Lease on Balance Sheet

The Finance Leases entry appears as an asset and liability in a company's financial statement. As payments are made, the lease liability decreases, thus making it possible for finance lease depreciation to reduce the asset's value over time.

Finance Lease vs Operating Lease

Business is leasing property. A finance lease or an operating lease is the only clear option besides a finance lease. These kinds of leases account for changes. There is also a difference between a finance lease and an operating lease in terms of their effect on an organization financially. A finance lease is the long-term period of asset use, whereas an operating lease is termed the short period of use. The Finances Difference and Basic Definitions

In a finance lease, the lessee has the use of an asset for most of its useful life. The lessee pays fixed rentals and records the asset in its balance sheet. On expiry of the lease, the asset may be acquired.

However, an operating lease will permit the lessee to use the asset for a short time. There will be no asset ownership by the lessee, which is not accounted for on the balance sheet. The lessor will maintain ownership and record depreciation.

Accounting Treatment

A finance lease involves recording the assets and liability in the lessee's books. It also consists of computing the finance lease depreciation and finance lease interest in the income statement. An operating lease's record only consists of expenses incurred from lease payments.

Feature	**Finance Lease**	**Operating Lease**
Ownership Transfer	Usually, at the end of the lease	No transfer remains with the lessor
Balance Sheet Impact	Asset and liability recorded	Not recorded in lessee's books
Expense Type	Depreciation and interest	Lease rental expense
Lease Term	Covers major asset life	Short-term use
Accounting Standard	Follows IFRS 16 rules	Considered an expense

Finance Lease Accounting

The finance lease accounting ensures the business's integrity concerning accounting norms. This states that lessees recognize and report financial leases on their balance sheets. At the lease commencement, the asset and liability must be recorded.

Finance Lease vs Capital Lease

People mistake a finance lease for a capital lease. A finance lease is governed by IFRS 16 while aging accounting standards govern a capital lease. Both pertain to asset transfer but differ in terminology. Key Differences

- A finance lease enters assets as right-of-use assets, while a capital lease will treat such assets as owned assets.
- The finance lease is governed by IFRS 16; older GAAP standards now guide the capital lease.

Finance Lease or Hire Purchase- Which Is Better for Business?

They all aid a business in acquiring assets but apply differently in the purchase process. A hire purchase allows it to acquire an asset after completing all payments. This is not always the case with finance leases.

- A finance lease needs the lessee to return the asset or buy it at fair market value.
- It provides evidence of possession of an asset once the last payment has been made.
- Asset accounting: a finance lease records the assets as right-of-use assets; hire purchase shows them as owned assets.

Different Pros and Cons of Finance Lease

A finance lease helps businesses access expensive assets, but it has limitations. They should weigh costs against benefits.

Advantages

- The business entity may initially use an asset without paying such an amount.
- Lease payments will be predictable and structured.
- Companies' cash flow improvements will be triggered if they lease instead of buying.

Disadvantages

- Over the lease term, the borrowed amount is higher than buying outright.
- The company has to maintain the asset at its own cost.
- An early termination of this lease may entail some penalty.

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Relevance to ACCA Syllabus

Finance leases are essential to the ACCA syllabus Financial Reporting (FR) and Strategic Business Reporting (SBR) . Understanding how to classify, recognize, and account for finance leases under IFRS 16 is crucial for preparing financial statements and ensuring compliance with international accounting standards. Knowledge of finance leases also supports advanced topics such as economic analysis and group reporting, making it a fundamental concept for ACCA candidates.

Finance Lease ACCA Questions

Q1: Under IFRS 16, how is a finance lease recognized in the lessee's financial statements?
A) As an expense in the income statement
B) As a lease liability and a right-of-use asset
C) As an operating lease expense
D) As an off-balance sheet item

Ans: B) As a lease liability and a right-of-use asset

Q2: Which of the following is a key characteristic of a finance lease?
A) The lease term covers only 10% of the asset's useful life
B) The lease agreement allows the lessee to purchase the asset at fair value
C) The lease transfers substantially all risks and rewards of ownership to the lessee
D) The asset remains recorded under the lessor's books throughout the lease term

Ans: C) The lease transfers substantially all risks and rewards of ownership to the lessee

Q3: What is the initial measurement of a finance lease liability under IFRS 16?
A) The fair value of the asset at inception
B) The present value of lease payments not yet paid
C) The total lease payments over the entire lease term
D) The lease payments plus maintenance costs

Ans: B) The present value of lease payments not yet paid

Q4: How are interest expenses related to finance leases recognized in financial statements?
A) As an operating expense
B) As a reduction in the right-of-use asset

C) As part of lease liability amortization
D) As a finance cost in the income statement

Ans: D) As a finance cost in the income statement

Q5: Under IFRS 16, which of the following is an impact of recognizing a finance lease?
A) Higher EBITDA due to lease expenses moving below the operating profit line
B) Lower total assets due to immediate expensing of lease payments
C) Decrease in liabilities as lease payments are made
D) Increased operating cash outflows due to lease interest payments

Ans: A) Higher EBITDA due to lease expenses moving below the operating profit line

Relevance to CMA (US) Syllabus

Finance leases are a significant part of the US CMA syllabus, particularly in the Financial Reporting and Planning section. Understanding the treatment of finance leases under US GAAP and IFRS is essential for financial managers responsible for budgeting, cost control, and decision-making. The impact of leases on financial statements and cash flows plays a vital role in economic analysis and planning.

Finance Lease CMA Questions

Q1: Under US GAAP, which criteria determine whether a lease is classified as a finance lease?
A) The lease is shorter than one year
B) The lessee has an option to return the asset at any time
C) The lease transfers ownership or meets at least one other specified condition
D) The lease is automatically renewed every year

Ans: C) The lease transfers ownership or meets at least one other specified condition

Q2: How does a finance lease affect a company's financial leverage ratio?
A) It reduces leverage by removing long-term liabilities
B) It increases leverage by adding lease liabilities to the total debt
C) It has no effect since lease payments are expensed
D) It reduces leverage by increasing operating income

Ans: B) It increases leverage by adding lease liabilities to total debt

Q3: In a finance lease, how is depreciation recorded?
A) No depreciation is recorded under finance leases
B) The lessee records depreciation on the right-of-use asset
C) The lessor records depreciation on the leased asset
D) Depreciation is recorded only if the asset is purchased at the end of the lease

Ans: B) The lessee records depreciation on the right-of-use asset

Q4: What impact does a finance lease have on the statement of cash flows?
A) Lease payments are recorded as an operating outflow
B) Principal repayments are classified as financing cash outflows
C) The entire lease payment is an investing cash outflow
D) Finance lease payments do not impact the cash flow statement

Ans: B) Principal repayments are classified as financing cash outflows

Q5: Which of the following best describes a lessee's benefit from a finance lease?
A) The ability to record lease payments as an expense
B) Ownership of the asset remains with the lessor
C) Use of an asset without immediate capital expenditure
D) The lease payments are not recorded on the balance sheet

Ans: C) Use of an asset without immediate capital expenditure

Relevance to CPA (US) Syllabus

Finance leases are covered under the US CPA exam's Financial Accounting and Reporting (FAR) section. Candidates must understand how leases impact financial statements under IFRS and US GAAP. The knowledge of finance leases helps in auditing, regulatory reporting, and economic decision-making, making it a crucial topic for CPA candidates.

Finance Lease CPA Questions

Q1: Under US GAAP, a finance lease must meet at least one of which criteria?
A) The lease term is less than one year
B) The lessee gains control of the asset's risks and rewards
C) The lessee pays lease expenses annually
D) The asset remains in the lessor's books throughout the lease term

Ans: B) The lessee gains control of the asset's risks and rewards

Q2: How does a finance lease impact the lessee's balance sheet?
A) Lease liability and right-of-use assets are recognized
B) Lease payments are recorded as an expense
C) The lease asset remains off-balance sheet
D) The leased asset is considered inventory

Ans: A) Lease liability and right-of-use assets are recognized

Q3: What financial statement effect does recognizing a finance lease have?
A) Increases total assets and total liabilities
B) Reduces total liabilities by treating the lease as an expense
C) Increases cash flow from investing activities
D) Decreases shareholder's equity

Ans: A) Increases total assets and total liabilities

Q4: What is the primary difference between operating and finance leases?
A) Operating leases transfer ownership at the end
B) Finance leases transfer risks and rewards of ownership
C) Finance leases do not require lease payments
D) Operating leases have higher depreciation costs

Ans: B) Finance leases transfer risks and rewards of ownership

Q5: Under US GAAP, where is the interest expense on a finance lease recorded?
A) Operating expenses
B) Financing expenses
C) Other income
D) Non-current liabilities

Ans: B) Financing expenses

Relevance to CFA Syllabus

Finance leases are relevant in the CFA curriculum, particularly in financial statement analysis. Understanding lease accounting allows analysts to evaluate a company's financial health and performance. CFA candidates must assess the impact of finance leases on leverage, cash flows, and profitability.

Finance Lease CFA Questions

Q1: How does a finance lease affect a company's return on assets (ROA)?
A) ROA decreases due to increased total assets
B) ROA remains unchanged
C) ROA increases due to lower depreciation
D) Finance leases have no impact on ROA

Ans: A) ROA decreases due to increased total assets

Q2: What is the effect of finance leases on EBIT?
A) EBIT increases since lease expenses are replaced by depreciation and interest
B) EBIT decreases as all lease payments are expensed
C) EBIT is unaffected by finance leases
D) EBIT fluctuates only at lease inception

Ans: A) EBIT increases since lease expenses are replaced by depreciation and interest

Q3: How are finance lease liabilities classified in financial statements?
A) Only as long-term liabilities
B) Only as short-term liabilities
C) Split between current and non-current liabilities
D) Not recorded in liabilities

Ans: C) Split between current and non-current liabilities

Q4: Which cash flow category includes finance lease principal repayments?
A) Operating activities
B) Investing activities
C) Financing activities
D) Non-cash transactions

Ans: C) Financing activities

Q5: Why do investors analyze finance leases in financial statements?
A) To assess hidden liabilities
B) To increase tax liabilities
C) To identify revenue sources
D) To manipulate EBIT

Ans: A) To assess hidden liabilities**

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