

RFHHA MANAGEMENT TIP OF THE DAY FOR HOSPITAL ADMINISTRATORS 1324

Learn the FM: What is capital lease in finance management?

A Capital Lease transfers (nearly) all of the risk and rewards of the leased property to the lessee. **Therefore it is considered to have the economic characteristic of asset ownership.**

A capital lease (also known as a **financial lease** or a **sales lease** or Sale and Leaseback) is a type of lease in which the finance company is typically the legal owner of the asset for the duration of the lease, while the lessee not only has operating control over the asset, but also some share of the economic risks and returns from the change in the valuation of the underlying asset.

A financial lease contract has typically following characteristics:

- The lessee (investor, customer or borrower) selects some asset (a car, equipment, software).
- The lessor (finance company) purchases that asset.
- The lessee uses the asset during the lease period.
- The lessee pays a series of rentals or installments to compensate for the use of the asset.
- The lessor recovers a part or all of the cost of the asset plus earns interest from the rentals paid by the lessee.
- The lessee has the option to acquire ownership of the asset (e.g., by paying the last rental, or by paying the bargain option purchase price).

ACCOUNTING TREATMENT OF FINANCIAL (CAPITAL) LEASE

In accounting capital leases are recorded as a purchase/sale on the balance sheet as both an asset and a related liability.

The firm can claim depreciation each year on the asset and can also deduct the interest expense component of the lease payment each year. In general, capital leases recognize expenses sooner than equivalent operating leases.

Since firms prefer to keep leases off the books, and sometimes prefer to defer expenses, there is a strong incentive on the part of firms to report all leases as operating leases. Consequently, in the India the Financial Accounting Standards has ruled that a lease should be treated as a capital lease if it meets any one of the following four conditions:

1. **The lease life exceeds 75% of the life of the asset.**
2. There is a transfer of ownership to the lessee at the end of the lease term.
3. There is an option to purchase the asset at a "bargain price" at the end of the lease term.
4. The present value of the lease payments, discounted at an appropriate discount rate, **exceeds 90% of the fair market value of the asset.**

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