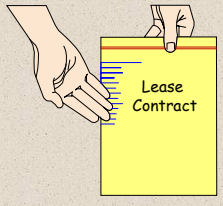
Accounting for Leases

Chapter 21

Basics of Leasing

A Lease is a contractual agreement between a lessor and a lessee that gives the lessee the right to use specific property, owned by the lessor, for a specified period of time in return for stipulated, and generally periodic, cash payments (rents)..



- Lease term
- Rental payments
- Executory Costs
- Restrictions
- Noncancelable
- Early termination
- Default

Advantages of Leasing

1. 100% Financing at Fixed Rates
2. Protection against Obsolescence
3. Flexibility
4. Less Costly Financing
5. Alternative Minimum Tax Problems
6. Off-Balance Sheet-Financing

Accounting by Lessee

The issue of how to report leases is the case of substance versus form. Although technically legal title does not pass in lease transactions, the benefits from the use of the property do.

Operating Lease		
Journal Entry:		
Rent expense	xxx	
Cash		xxx

Capital Lease		
Journal Entry:		
Leased equipment	xxx	
Lease obligation		xxx

A lease that transfers substantially all of the benefits and risks of property ownership should be capitalized (only noncancellable leases may be capitalized).

Statement of Financial Accounting Standard No. 13, "Accounting for Leases," 1980

Mechanics

The expense recorded on a capital lease and an operating lease are THE SAME over the life of the asset. In a capital lease it hits the P&L via interest expense and depreciation expense VS operating, it all goes into rent expense.

In a capital lease, think of it as a sale. The commitment to the lessor is a debt and should be treated like any other debt (current vs. noncurrent, accrue interest etc.) The asset gets depreciated just like if it were owned/purchased.

Compare capital vs. operating lease

FACTS		
Lease a computer worth	3,000	
Lease term	3	yrs
Annual payment	1,143	
Estimated life of a computer	4	yrs
Effective borrowing rate	7%	

PRESENT VALUE OF PAYMENTS	$3,000
ANNUAL DEPRECIATION	$750

CAPITAL LEASE	OPENING	YEAR ONE	YEAR TWO	YEAR THREE	YEAR FOUR
Equipment	3,000				
Cap lease obligation	3,000				
Cash		1,143	1,143	1,143	
Interest expense		210	145	75	0
Capital lease obligation		933	998	1,068	(0)
Depreciation expense		750	750	750	750
Accumulated depreciation		750	750	750	750

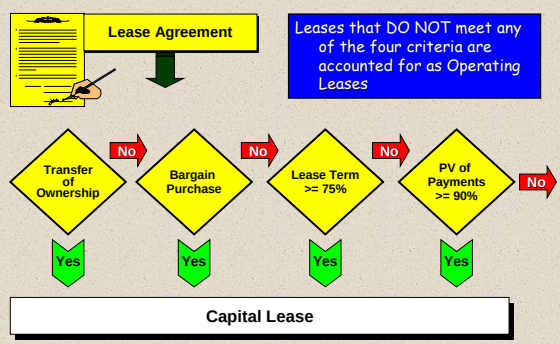
OPERATING LEASE					
Rent expense	NO OPENING ENTRY!	1,143	1,143	1,143	
Cash		1,143	1,143	1,143	

COMPARE EXPENSE OF THE TWO:

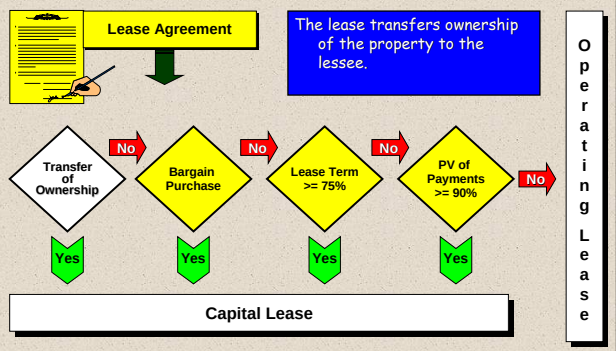
CAPITAL LEASE		OPERATING LEASE	
Interest expense	429	Rent expense	3,429
Depreciation expense	3,000		
	3,429		

DIFFERENCE BETWEEN THE TWO OVERALL: NONE!!!!

Capitalization Criteria



Capitalization Criteria



Capitalization Criteria

Lease Agreement

Transfer of Ownership — No → Bargain Purchase — No → Lease Term >= 75% — No → PV of Payments >= 90% — No →

Yes | Yes | Yes | Yes

Capital Lease

Operating Lease

Capitalization Criteria

Lease Agreement

Lease term can be extended by a bargain renewal option.

Transfer of Ownership — No → Bargain Purchase — No → Lease Term >= 75% — No → PV of Payments >= 90% — No →

Yes | Yes | Yes | Yes

Capital Lease

Operating Lease

Capitalization Criteria

Lease Agreement

Three important concepts:

- Minimum lease payments
- Executory costs
- Discount rate

Transfer of Ownership — No → Bargain Purchase — No → Lease Term >= 75% — No → PV of Payments >= 90% — No →

Yes | Yes | Yes | Yes

Capital Lease

Operating Lease

Capitalization Criteria

Lease Agreement

Minimum lease payments:

- Guaranteed residual value
- Penalty for failure to renew
- Bargain purchase option

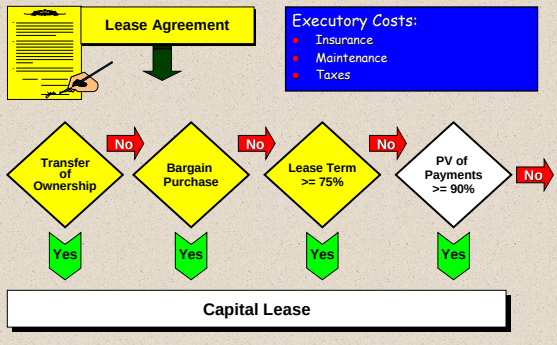
Transfer of Ownership — No → Bargain Purchase — No → Lease Term >= 75% — No → PV of Payments >= 90% — No →

Yes | Yes | Yes | Yes

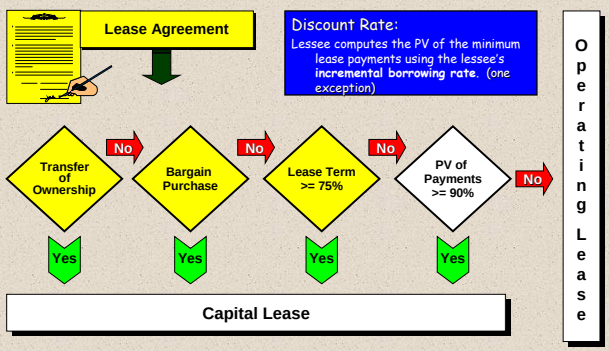
Capital Lease

Operating Lease

Capitalization Criteria



Capitalization Criteria



REAL WORLD

The leasing companies are hip to these criteria and go out with a lease that they believe satisfies the requirements. They usually run really tight (i.e PV of payments is 89.9% of the fair value of the asset).

Just because the leasing company says it works as an operating lease, doesn't make it so!!

TEXT example from p.1097

Lessor and Lessee sign a lease agreement dated January 1, 2005 which requires Lessor to lease equipment to lessee beginning January 1, 2005. Terms are:

- 5 year, noncancelable lease term, equal annual payments at beginning of year of $25,981.62
- Fair value of equipment is $100,000 at inception and has 5 yr. Life and no residual value
- Lessee pays all executory costs directly, except property tax which is $2,000 per year and part of the annual payment of $25,981.62
- No renewal options and equipment reverts to Lessor at termination
- Lessee borrowing rate is 11%, Lessor implicit rate is 10% and known to Lessor
- Lessee depreciates on a straight line basis.

Instructions

Prepare the journal entries on the books of the Lessee that relate to the lease agreement through December 31, 2009.

p. 1097 SOLUTION

Payment	25,981.62
Property tax	(2,000.00)
Lease portion	23,981.62
Rate	10% *
Period	5
PV	100,000
Life of asset	5

** smaller of lessee borrowing rate or lessor implicit rate*

IS THIS A CAPITAL LEASE? YES- 100% OF LIFE IS>75% AND Pv of Payments>90%

LEASE AMORTIZATION SCHEDULE

	LEASE PMT	INTEREST	LEASE REDUX	LEASE LIABILITY
1/1/05- OPENING				100,000.00
1/1/05 PAYMENT	23,981.62	-	23,981.62	76,018.38
1/1/06 PAYMENT	23,981.62	7,601.84	16,379.78	59,638.60
1/1/07 PAYMENT	23,981.62	5,963.86	18,017.76	41,620.84
1/1/08 PAYMENT	23,981.62	4,162.08	19,819.54	21,801.30
1/1/09 PAYMENT	23,981.62	2,180.13	21,801.49	-

OPENING ENTRY:

Equipment	100,000	
Capital lease obligation		100,000

1/1/05 ENTRY:

Lease liability	23,982	
Property tax expense	2,000	
Cash		25,982
		-

12/31/05 ENTRY:

Interest expense	7,602	
Depreciation expense	20,000	
accum dep		20,000
Accrued interest		7,602
		-

1/1/06 PAYMNT:

Property tax expense	2,000	
Lease liability	16,380	
Interest payable	7,602	
Cash		25,982
		-

ETC.

RESIDUAL VALUE- LESSEE

Accounting depends on whether the residual is guaranteed or not:

- **Not Guaranteed: As if it did not exist**
- **Guaranteed: As if the guaranteed amount is a final payment (gain/ loss results on final payment depending on what the value of the property is)**

BARGAIN PURCHASE OPTION

DISCOUNT THE BARGAIN! (if get 10 for 2, then what is the PV of the cost of the $8 bargain??

The cost= PV of the $2 payment))

If there is a bargain purchase option, then you assume it will be paid and the asset transferred at the end of the term. Think of it as a final lease payment. For instance- 3 year lease at $100 per year, 10% implicit rate. Can buy the item for $75 at the end of the term when it's fair value would be $150. Then the PV of the payments is:

PV of lease payment	**$250**
PLUS PV of $75 in the future	**$ 56**
PV of the lease	**$306**

Illustration

E21-2 Pat Delaney Company leases an automobile with a fair value of $8,725 from John Simon Motors, Inc., on the following terms:

1. Noncancelable term of 50 months
2. Rental of $200 per month (at end of each month; present value at 1% per month is $7,840).
3. Estimated residual value after 50 months is $1,180 (the present value at 1% per month is $715). Delaney Company guarantees the residual value of $1,180.
4. Estimated economic life of the automobile is 60 months.
5. Delaney Company's incremental borrowing rate is 12% a year (1% a month). Simon's implicit rate is unknown.

Instructions

Prepare the journal entries on the books of Delaney Company for the first month of the lease.

Solution E21-2

FACTS

Term of lease	50	months
Monthly rent	200	
Rate	12%	
Guaranteed res. Value	1,180	
Life of asset	60	months

This is a capital lease because two of the criteria are met (only need one met)

Lease term	50
Life of asset	60
	83% > 75% requirement

PV of payments (since residual is guaranteed, it is included)

PV of payments	$7,839.22
PV of residual	$717
	$8,556.71

ENTRY TO RECORD:

Leased equip under cap lease	$ 8,556.71	
Lease liability		$ 8,556.71

1st Month Entry:

Depreciation expense	$ 147.53	
Accum. Dep		$ 147.53
Lease liability	$ 114.43	
Interest expense	$ 85.57	
Cash		$ 200.00

Benefits Available To The Lessor

1. Interest Revenue
2. Tax Incentives
3. High Residual Value

Capitalization Criteria (Lessor)

Group I

- Transfer of ownership
- Bargain purchase option
- Lease term => 75% of economic life of leased property
- Present value of minimum lease payments => 90% of FMV of property

Group II

- Collectibility of the payments required from the lessee is reasonably predictable.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease (lessor's performance is substantially complete or future costs are reasonably predictable).

Why Group II Requirements?

LESSOR: DIRECT FINANCING VS. SALES TYPE LEASES

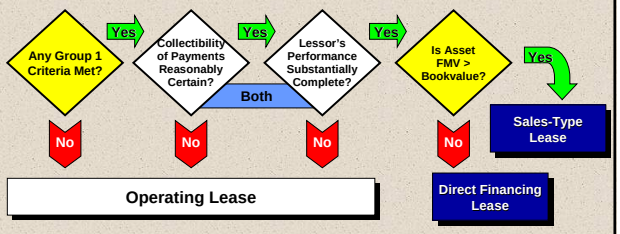
IF ALL THE CRITERIA ARE MET, THEN IT IS EITHER A DIRECT FINANCING OR SALES-TYPE LEASE TO THE LESSOR:

- **Direct Financing: Lessor is not making money from selling the product, they are in it for the financing aspect (more like a lender). It works just like the capital lease we just spoke of for lessee, but in reverse (interest income, lease receivable VS interest expense , interest receivable)**
- **Sales-Type: Lessor is getting a financing fee, but ALSO is making money from the product itself as well (they may be a manufacturer or retailer). More complicated- need to deal with any profit the lessor is making from selling the asset.**

Capitalization Criteria (Lessor)

Lease Agreement

Group 1 criteria are the four criteria that must be considered for capitalization of a lease by a lessee.



LESSOR- DIRECT FINANCING

Payment	100
period	3
rate	8%
PV	258
FV	258
Cost	258

UPON "SALE"		
Cap lease receivable	258	
Asset		258
YR 1		
Cash	100	
Interest income		21
Cap lease receivable		79
YR 2		
Cash	100	
Interest income		14
Cap lease receivable		86
YR 3		
Cash	100	
Interest income		7
Interest income		93

LESSOR: SALES TYPE

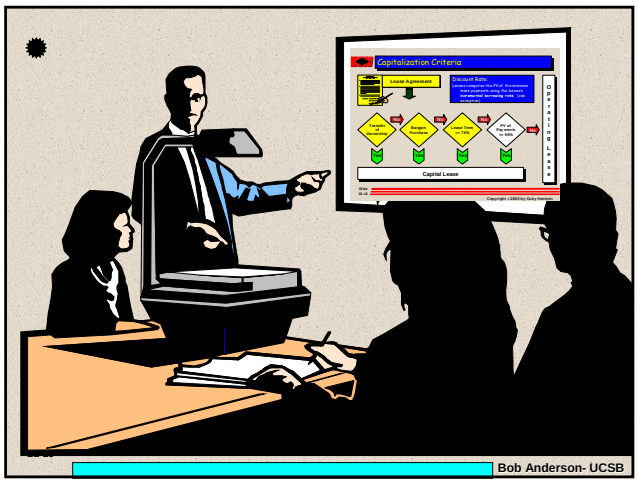
Payment	100
period	3
rate	8%
PV	258
FV	258
Cost	200

UPON "SALE"		
Cap lease receivable	258	
Asset		200
Gain		58
YR 1		
Cash	100	
Interest income		21
Cap lease receivable		79
YR 2		
Cash	100	
Interest income		14
Cap lease receivable		86
YR 3		
Cash	100	
Interest income		7
Interest income		93

Capitalization Criteria (Lessor)

Is it possible that a lessor having not met both criteria will classify a lease as an operating lease but the lessee will classify the same lease as a capital lease?

In such an event, who will have the asset on their books?



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