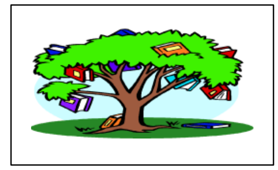
Toward Business Literacy: Accounting Outlines



Leases

A **lease** is a contractual agreement between a lessor (owner) and a lessee for a period of time in return for stipulated, periodic cash payments

- **Duration** refers to the lease term
- **Payments** can be level or variable
- **Executory** costs are taxes, insurance and maintenance on the property
- **Restrictions** limit lessee's activities such as paying dividends and taking on new debt to protect lessor from lessee's default and ensure payments
- **Terms** involve cancellation, early termination, default provisions, and subleases to 3rd parties

Advantages of Leases

- 100% financing at fixed rates conserves cash and protects from inflation
- Protects against obsolescence; the residual value goes back to the lessor
- Flexibility: leases are less restrictive than debt; payments can be arranged to coincide with cash flows from the leased asset
- Less costly financing: start-ups and lower tax brackets do not benefit from depreciation deduction for owned assets, therefore a lease is wiser
- Tax advantages: operating leases don't report asset or liability (financial), and capital lease is depreciated (tax benefit)
- Off balance-sheet financing: leases do not add debt to capital structure

Capitalizing of Leases

- No capitalization: lessee has no ownership in an operating lease
- Capitalize: lease is similar to an installment purchase (economic substance)
- FASB says to capitalize lease where lease transfers substantially all of the benefits and risks of property ownership, with penalty for nonperformance

Criteria for Capital Leases

- If a lease meets at least one of the following criteria, then it is a capital lease:
  - Lease transfers ownership to lessee
  - Lease contains a bargain purchase option (BPO)
    - This is an arrangement to purchase asset at significant reduction
  - The lease term is 75% or more of the economic life of the asset
  - The present value of minimum lease payments (MLP) is greater than or equal to 90% of the fair market value (FMV) of the asset
  - Capital leases are of two types:
    - **Direct financing** realizes no profit on asset transfer
    - A **Sales-type** lease involves profit (when FMV is greater than the carrying value of the asset); recognize a gain or loss
- If none of these are met, the lease is an operating lease

Account for an operating lease with expense to lessee and revenue to lessor

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Special Accounting Problems with Leases

Residual Values

- The lessor may want the assurance of a set value of the leased asset to be returned at the end of the lease term if there is no title transfer or BPO
- A guaranteed residual value by lessee is to make up the deficiency if the assets FMV is below a stated amount at the end of the lease term
- FMV of leased asset less the PV of residual value = amount to be received by lessor through payments
- The lessee adds PV of a guaranteed residual value to MLP

Sales Type Lease

- Lease receivable = PV of MLP + PV of unguaranteed residual value
- Sales price = Present Value of Minimum Lease Payments
- Cost of Goods Sold = Cost of the Asset
- Lessor Recognizes Profit or Loss (Sales less Cost of Goods Sold, above)

Bargain Purchase Option

- Increase PV of MLP by PV of option price
- Depreciation term for guaranteed residual value and BPO:
  - Lease term for residual value
  - Economic life for BPO

Initial Direct Costs (Lessor)

- Incremental Direct Costs are paid to independent third parties
  - Include costs such as appraisal, credit checks, and brokers
- Internal direct costs include evaluation of lessee, recording, collateral checks, terms negotiation, document preparation
- Do not include indirect costs such as advertising, credit policies, etc.
- For an operating lease, defer initial costs and allocate over lease term
- For a sales-type lease, expense in year of incurrence
- For direct financing leases, add costs to net investment and amortize

Current and non-current portions

- For a current liability portion, rework PV based on an ordinary annuity
  - Balance at the end – balance at the end of next year = current

Footnote disclosures:

- future payments, contingencies, subleases, restrictions

Sale-leasebacks are where the lessee sells asset and leases it back; no gain or loss is recognized unless seller gives up right to use; if FMV < BV, recognize loss

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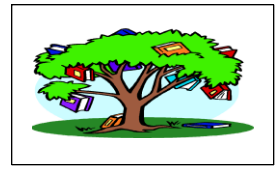

Lease Accounting

Present value of lease payments

- Minimum lease payments:
    - Composed of minimum rent payments, a guaranteed residual value, penalties for failure to renew or extend the lease, and the BPO
- Executory costs: if lessor retains responsibility, a portion of payment that includes these costs should be excluded
- Discount rate: present value of payments uses lessee's **incremental borrowing rate** (the rate that would have been incurred to borrow funds on similar repayment terms)
    - Exception: if lessee knows the lessor's **implicit rate** and it is less than the incremental rate, use the lessor's rate
- Present value = Fair market value of property (minimum payments and unguaranteed residual)

Initial Asset and Liability for Capital Lease

Initial JE of lessee	Leased Equipment under capital lease		xxx
	Lease Liability	xxx	

The lower of PV of MLP or FMV of leased asset at the start

- The amount of the liability is the minimum lease payments
    - (Rent payment – executory costs) x PV of annuity due of 1 (#per, rate)

Initial JE of lessor	Lease Receivable	xxx	
	Asset		xxx

Remove asset from books

Depreciation (for asset) and **recognition of principal and interest** with payments are *independent* accounting processes

- If the lease transfers ownership or has a BPO → use economic life of asset
- Otherwise use the term of the lease
- There is *no depreciation* for the lessor in a capital lease or operating lease

Depreciation (lessee)	Depreciation Expense-Capital Lease	xxx	
	Accumulated Depr- Capital Lease		xxx

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Recording Receipts by Lessor

1st receipt	Cash	xxx	
	Lease Receivable		xx
	Property taxes payable		x

Reduce Receivable and record liability for executory cost

1st yr revenue	Cash	xxxx	
	Lease Receivable		xxx
	Interest Revenue		xx
	Executory Costs payable		x

Notice this contains interest revenue for first year

If asset is sold at end	Cash	xxx	
	Gain on sale of leased equipment		xxx

Recording Payments by Lessee

1st payment	Property Tax Expense	xxx	
	Lease Liability		xxx
	Cash		xxx

Yearly payment	Property Tax Expense	x	
	Interest Expense	xx	
	Lease Liability	xxx	
	Cash		xxxx

- Interest expense is by the effective interest method
    - Expense = lease liability carrying value x rate

From Intermediate Accounting by Keiso
Last modified 7/26/2013