

Leases

Objectives

Understand the rationale for leasing and the distinction between Operating and capital leases.

Understand the Income Statement and Balance Sheet differences Between operating and capital leases from the lessee's perspective.

The Nature of Leases

A lease is an agreement conveying the right to use property, plant, or equipment usually for a stated period of time.

The owner of the property is referred to as the lessor, and the renter is the lessee.

Two basic questions related to leasing:

- 1) What is the economic rationale for leasing rather than purchasing an asset? (**Finance/Economic question**)
- 2) Should a given arrangement be treated as a rental or purchase for financial reporting purposes? (**Accounting question**)

Finance/Economic Question

Advantages to Leasing

Operational advantages to the lessee:

- ▶ Leasing ready-to-use equipment may be more attractive if the asset requires lengthy preparation and set-up.
- ▶ Leasing avoids having to own the asset that will be required only seasonally, temporarily or sporadically.
- ▶ Leasing for short periods provides protection against obsolescence.

Financial advantages to the lessee:

- ▶ Lease payments can be tailored to suit the lessee's cash flows (up to 100% financing, instead of the 80% limit by banks).
- ▶ Properly structured leases may be “off-balance sheet”, avoiding Restrictions set by bondholders that prevent firm from taking on additional debt.
- ▶ Leasing provides tax advantages from accelerated depreciation and interest expense.

Finance/Economic Question

Disadvantages to Leasing

Disadvantages to the lessee:

- ▶ Leased ready-to-use equipment may be of lower quality than custom built, resulting in lower quality products and lower sales.
- ▶ Seasonal leasing may affect equipment availability and pricing.
- ▶ Premium must be paid for the protection against obsolescence.

Disadvantages to financial statement users:

- ▶ Off-balance sheet financing hides the true leverage of the firm.

Accounting Question

What is the Economic Substance of the Arrangement?

Possible arrangements between lessor and lessee

Rent

Own

Treat these as a rental?

Treat these as a purchase?

- *Operating lease* – (rental) lessee rents the property. Lessee accrues rent expense.
- *Capital lease* - (purchase) lessee essentially owns the property. Lessee records the leased asset in the balance sheet (i.e. capitalized) together with the corresponding lease obligation.

Where do we draw the line between rental and purchase accounting treatment?

Accounting Criteria for Lease Capitalization

In theory, a lease should be capitalized if the risks and rewards of ownership are transferred from the lessor to the lessee. In practice, a lease is considered a capital lease if ANY of the following conditions apply (from SFAS 13):

- 1. Essential transfer of ownership at the end of lease term**
 - No payment for leased asset, or
 - Bargain purchase option (BPO) - payment below market value after the lease term.
- 2. Minimum present value of lease payments (including BPO, if any) at least 90% of asset's market value**
- 3. Lease term is 75% of assets remaining useful life**

Accounting for capital leases--Lessee's Books

A capital lease is recorded as an acquisition of an asset with 100% debt financing in the financial statements.

When the lease agreement is signed and lessee begins using the asset:

<u>Leased Property</u>		<u>Lease Obligation</u>
PVL	-	PVL

During the lease (as payments are made)

<u>Cash</u>	<u>-Acc. Depr.</u>		<u>Lease Obligation</u>	<u>Retained Earnings</u>
(PP)	Depr	-	(PP - Int)	(Int) (int. exp.)
				(Depr) (dep. exp.)

PVL = present value of periodic lease payments = (PV of ordinary annuity, n payments, r %) * PP

PP = periodic lease payment

Int = Beginning lease liability * r%,

Beginning lease liability = present value of remaining payments at r%

Depr = depreciation expense

Capital Leases: An Example

Delta transactions:

If treated as an capital lease

When the lease agreement is signed and lessee begins using the asset:

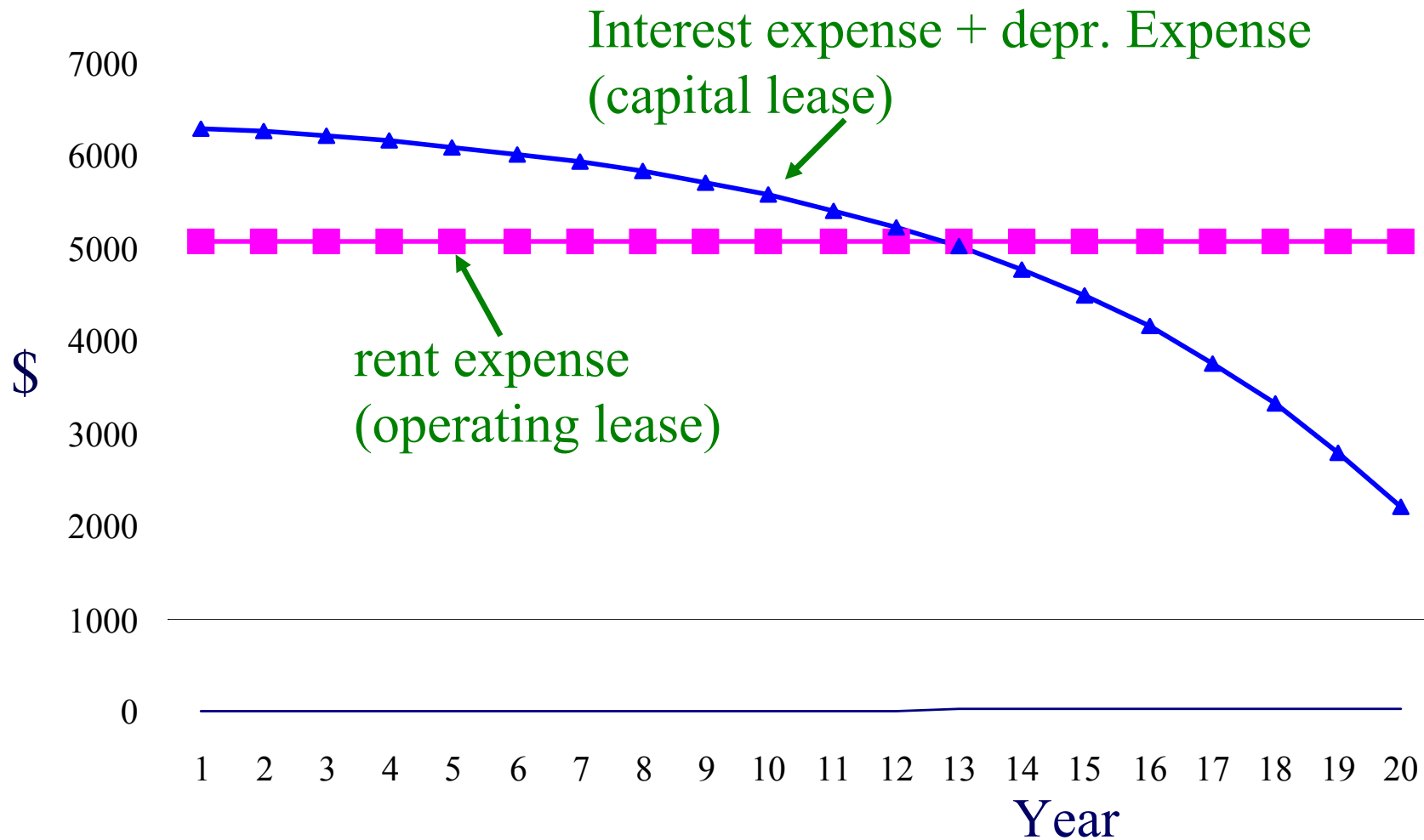
Leased Property(A)
30,000

Lease Obligation(L)
30,000

During the lease (as payments are made):

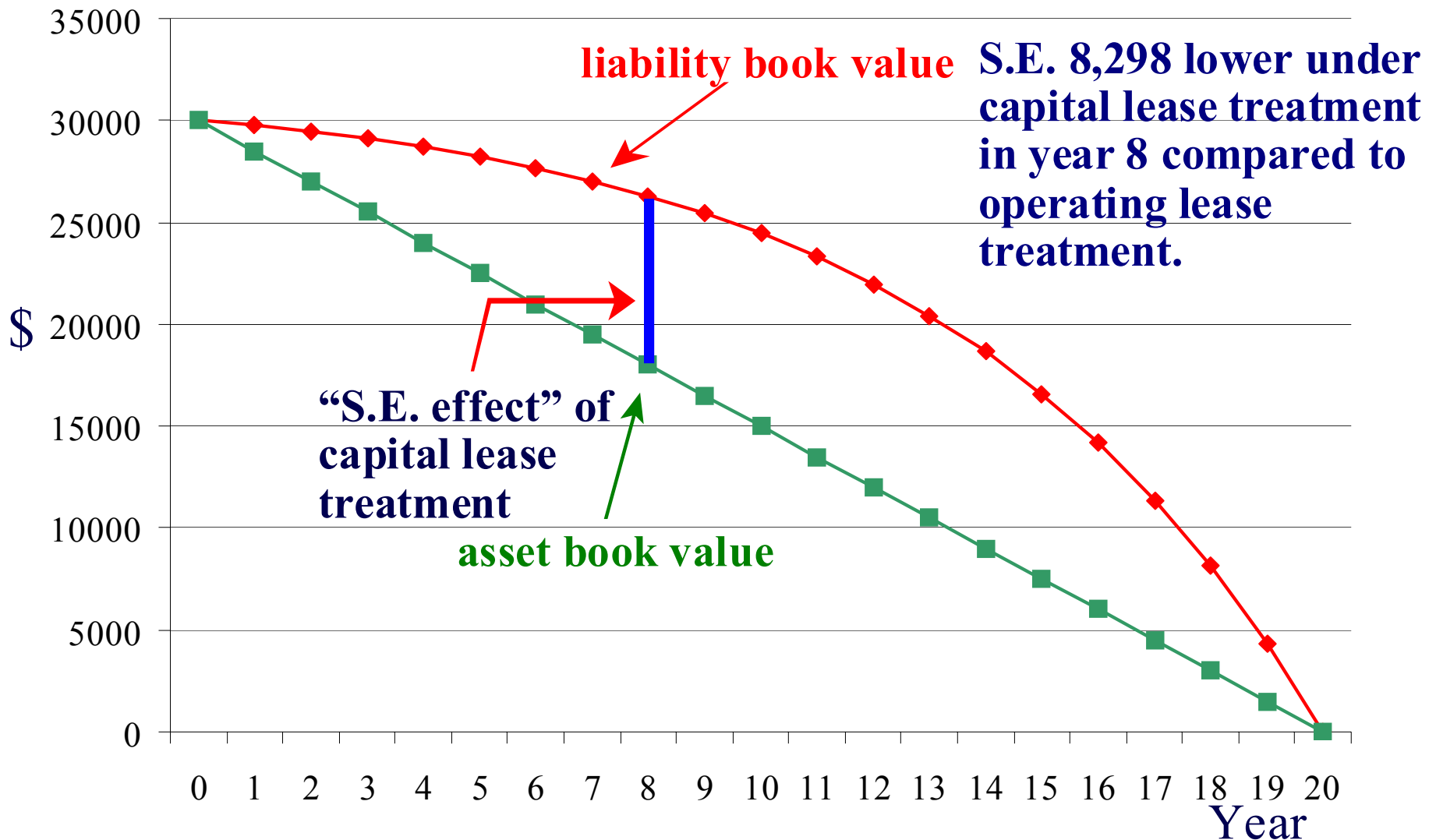
	<u>Cash(A)</u>	<u>Leased Property(A)</u>	<u>-Acc Depr.(A)</u>	<u>Lease Obligation(L)</u>	<u>Retained Earnings(SE)</u>
Y1					
EBY1					
Y2					
EBY2					
Y3					
EBY3					

Capital v Operating Lease: I/S Effects



Capital v Operating Lease: B/S Effects

Annual pattern of asset and liability values over time for capital lease:



Financial statement disclosures -- Target

Based on information in the lease footnote, what value does Target show for lease liability on its Balance sheet?

The footnote says Target's borrowing rate is 8.8 percent. Could this amount be independently computed?