Leases

Chapter 12

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• **Leasing** is an alternative means of acquiring long-term assets to be used by business firms

• **Leasing** that are not in-substance purchases provide for the right-to-use property by lessees in contrast to purchases that transfer property rights to the user of the long-term asset.

• **Leasing** terms generally obligate lessees to make a series of payments over a future period of time.

• **If a lease is correctly structured** → it enables the lessee to engage in off-balance sheet financing because certain leases are not recorded is long term debt on the balance sheet.

• Leasing have become a popular method of acquiring property because of the following advantages:
  1. it offers 100 percent financing.
  2. it offers protection against obsolescence.
  3. it is frequently less costly than other forms of financing the cost of the acquisition of fixed assets.
  4. if the lease qualifies as an operating lease, it does not add debt to the balance sheet.

• Management choice between purchasing and leasing is a function of:
  - strategic investment
  - capital structure objectives

  the competitive costs of purchases of asset versus:
  - leasing assets
  - the availability of tax benefits
  - perceived financial reporting advantages
• **Two predominant methods** for allocating lease revenues and expenses to the periods covered by the lease agreement have emerged in accounting practice:

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<th>Capital lease</th>
<th>operating lease</th>
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<td>Is <strong>based</strong> on the view that the constitutes an agreement through which the lesser finances the acquisition of assets by the lessee.</td>
<td>Is <strong>based</strong> on the view that the lease constitutes a rental agreement between the lessor and lessee.</td>
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Capital leases are in–substance installment purchases of assets.

• **The basic accounting questions associated with leases are:**

  1. what characteristics of the lease agreement require a lease to be reported as in substance long–term purchase of an asset?

  2. which characteristics allow the lease to be recorded as a long-term rental agreement?

• the conceptual foundation underlying SFAS No 13 is based on the view that "a lease that transfer substantially all of the **benefits** and **risks** incident to the ownership of property should be **accounted** for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor."
• This viewpoint leads immediately to three basic conclusions:

1. the characteristics that indicate that substantially all the benefits and risks of ownership have been transferred to the lessee must be identifiable.
   ⇒ these leases should be recorded if they involved the purchase and sale of assets 'capital lease'

2. the same characteristics should apply to both the lessee and lessor
   ⇒ the inconsistency in accounting treatment the previously existed should be eliminated.

3. leases that do not meet the characteristics identified (1) should be accounted for as rental agreements 'operating leases'

• Smith and Wakeman identified eight nontax factors that make leasing more attractive than purchase:

1. the period of use is short relative to the overall life of the asset.

2. the lessor has a comparative advantage over the lessee in reselling the asset.

3. corporate bond covenants of the lessee contain restrictions relating to financial policies the firm must follow (maximum debt-to-equity ratios).

4. management compensation contracts contain provisions expressing compensation as a function of return on invested capital.

5. lessee ownership is closely held so that risk decrease is important.

6. lessor (manufacturer) has market power and can thus generate higher profits by leasing the asset (and controlling the terms of the lease) than by selling the asset.
7. the asset is not specialized to the firm.

8. the assets value is not sensitive to use or mistreatment (owner takes better care of the asset than does the lessee)

criteria for classifying leases:

- In SFAS No 13 the FASB outlined specific criteria to help in classifying leases as either capital or operating leases. In the case of the lessee, if at its inception the lease meets any one of the following four criteria the lease is classified as a capital lease; otherwise, it is classified as an operating lease:
  
  1. the lease transfers ownership of the property to the lessee by the end of the lease term.
  2. the lease contains a barging purchase option.
  3. the lease term is equal to 75% or more the estimated remaining economic life of the leased property, unless the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property.
  4. at the beginning of the lease term the present value of the minimum lease payments (the amount of the payments the lessee is required to make excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessee) equals or exceed 90% of the fair value of the leased property less any related investment tax credit retained by the lessor.

- In the case of the lessor (except for leveraged leases) if a lease meets any one of the preceding four criteria plus both the following additional criteria, it is classified as a sales type of direct financing lease 'capital lease':
  
  1. collectibility of the minimum lease payments is reasonably predictable.
2. no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

**accounting and reporting by lessees under SFAS No 13**

- **In opinion No 5 the APB asserted** that a noncancelable lease or cancelable on the occurrence of some remote contingency was probably in substance a purchase if either of the two following conditions exists:

  1. the initial term is materially than the useful life of the property and the lessee has option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value.

  2. the lessee has a right, during or the ending of the lease to acquire the property at a price that at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

- **the APB** went on to say that one or more of the following circumstances tend to indicate that a lease arrangement substance as purchase:

  1. the property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.

  2. the term of the lease corresponds substantially to the estimated useful life of the property and the lessee is obligated to pay costs such as taxes, insurances, and maintenance which are usually considered incidental to ownership.
3. the lessee has guaranteed the obligations of the lessor with respect of the leased property.

4. the lessee has treated the lease as a purchase for a tax purposes.

- a lease should be reported as a purchase if a primary purpose of ownership of the property by the lessor is to the lessee and:
  1. the lease payments are pledged to safe the debts of the lessor
  2. or the lessee is able, directly or indirectly to control or influences significantly the actions of the lessor with respect to the lease.

- noncapitalized lease provide the following benefits:
  1. improved accounting rate of return and debt ratios, thereby improving the financial picture of the company.
  2. better debt ratings.
  3. increased availability of capital.
Capital leases

- the view expressed in APB opinion No. 5 concerning the capitalization of those leases that are "in – substance installment purchases" are significant from a historical point of two reasons:

1. In SFAS No. 13, the FASB based its conclusion on the concept that a lease that "transfers substantially all of the benefits and risks of the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee, and as a sale or financing by the lessor"

2. To a great extent, the accounting provision of SFAS No. 13 applicable to lessees generally follow APB opinion No 5.

- The provision of SFAS No. 13 require a lessee entering into a capital lease agreement to record both an asset and a liability at the lower of the following:

1. The sum of the present value of the minimum lease payments at the inception of the lease.

2. The fair value of the leased property at the inception of the lease.

- The following items are subject to inclusion in the determination of the minimum lease payments:

1. Minimum real payments over the life of the lease.

2. Payment called for by a barging purchase option.

3. Any guarantee by the lessee of the residual value at the ending of the lease term.

4. Any penalties that the lessee can be required to be for failure to renew the lease.

⇒ once the minimum lease payments or fair market value is determined, the next step is to compute the present value of the lease payments.
⇒ the interest rate to be used in this computation is generally the lessee's incremental borrowing rate.

- capital lease assets and liabilities are to be separately identified in the lessee's balance sheet or in the accompanying footnotes the liability should be classified as current and noncurrent on the same basis as all other liabilities, that is according to when the obligation must be paid.

- SFAS No. 13, require the each minimum payment under a capital lease deallocated between a reeducation of the liability and interest expense.

Disclosure requirements for capital lease

- The following information must be disclosed in the lessee's financial statements or in the accompanying footnote:

  1. the gross amount of assets recorded under capital leases as of the date of each balance sheet presented by major classes according to nature or function.

  2. future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years.

  3. the total minimum sublease rentals to be received in the future under noncancelable sublease as of the date of the latest balance sheet presented.

  4. total contingent rentals (rentals on which the amounts are dependent on some factor other than the passage of time) actually incurred for each period for which an income statement is presented.