Leases

Definitions
- **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 substantial 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