

7. Equipment Leases

Many businesses acquire needed assets via a lease arrangement. With a lease arrangement, the lessee pays money to the lessor for the right to use an asset for a stated period of time. In a strict legal context, the lessor remains the owner of the property. However, the accounting for such transactions looks through the legal form, and is instead based upon the economic substance of the agreement.

If a lease effectively transfers the “risks and rewards” of ownership to the lessee, then the applicable accounting rules dictate that the lessee account for the leased asset as though it has been purchased. The lessee records the leased asset as an item of property, plant, and equipment, which is then depreciated over its useful life to the lessee. The lessee must also record a liability reflecting the obligation to make continuing payments under the lease agreement, similar to the accounting for a note payable. Such transactions are termed “capital leases.” You should note that the basic accounting outcome is as though the lease agreement represents the purchase of an asset, with a corresponding obligation to pay it off over time (the same basic approach as if the asset were purchased on credit).

Of course, not all leases effectively transfer the risks and rewards of ownership to the lessee. The determination of risk/reward transfer is based upon evaluation of very specific criteria: (1) ownership transfer of the asset by the end of the lease term, (2) minimum lease payments with a discounted present value that is 90% or more of the fair value of the asset, (3) a lease term that is at least 75% of the life of the asset, or (4) some bargain purchase element that kicks in before the end of the lease. If a lease does not include at least one of the preceding conditions, it is deemed not to be a “capital lease,” and is thus considered to be an “operating lease.” You will be relieved to know that you have already studied “operating leases” in the earliest chapters of this book -- that is, rent is simply recorded as rent expense as incurred -- the underlying asset is not reported on the books of the lessee.

Your life’s experiences may give you a basis for extending your understanding of leases. If you have rented an apartment at some point in your life, consider how it would be accounted for by you – as a capital lease or an operating lease? None of the “4” criteria was likely met; thus, your agreement was an operating lease. In the alternative, you may have leased a car. It is possible (not assured) that your lease agreement would trigger one of the four criteria. If you were to follow generally accepted accounting principles for such an agreement, you would have recorded both an asset (the car) and the liability (obligation under capital lease) on your books the day you drove away from the dealer (in debit/credit context, you debit the asset and credit the liability for an amount that approximates the fair value -- I’ll leave those details for intermediate accounting courses).

Now, you may wonder why all the trouble over lease accounting? However, if you think about an industry that relies heavily on capital lease agreements, like the commercial airlines, you can quickly come to see the importance of reporting the planes and the fixed commitment to pay for them. To exclude them would render the financial statements not representative of the true nature of the business operation.