

Week 3 - DQ 1

Capital leases and operating leases are the two classifications of leases described in FASB pronouncements from the standpoint of the lessee.

Describe how an operating lease would be accounted for by the lessee both at the inception of the lease and during the first year of the lease, assuming the lessee makes equal monthly payments at the beginning of each month of the lease.

Describe the change in accounting, if any, when rental payments are not made on a straight-line basis.

Response #1

When dealing with an operating lease there is no asset or liability to record. Only the amount that is paid would be recorded as an expense.

Under an operating lease, the lessee records rent expense (debit) over the lease term, and a credit to either cash or rent payable. If an operating lease has scheduled changes in rent, normally the rent must be expensed on a straight-line basis over its life, with a deferred liability or asset reported on the balance sheet for the difference between expense and cash outlay. Under an operating lease, the lessor records rent revenue (credit) and a corresponding debit to either cash/rent receivable. The asset remains on the lessor's books as an owned asset, and the lessor records depreciation expense over the life of the asset

http://en.wikipedia.org/wiki/Accounting_for_leases_in_the_United_States)

Here are a few calculations:

[Monthly Lease Payment] x [Term (months)] = [Total amount out of pocket]

[Total amount out of pocket] - [Financed amount] = [Total finance charge]

[Total finance charge] / [Term (years)] = [Finance charge per year]

[Finance charges per year] / [Financed amount] = Annual Lease Rate

Response #2

An operating lease should be accounted for as a straight line expense on the income statement and should reflect the out flow of cash or post a liability to rent payable. If payments are not made in a straight-line basis, the expense is still recognized in a straight-line basis unless another rational basis better fits the time pattern of the lease.

<http://www.fasb.org/pdf/fas13.pdf>

Response #3

If a lessee enters in to an operating lease with a lessor the lease payments are not accounted for by the lessee on the balance sheet. The amounts will still have an effect on the cash flow of a business but does not affect the working capital of a company.

For operating leases, unless otherwise stated, will be calculated using straight-line method. This means that even though the lease is paid monthly or annually the total amount of the lease is calculated and then divided. For example, if a company signs a lease for five years at \$60,000 then the amount would be viewed as monthly installments of \$1,000 or annual of \$12,000.

If I understand this correctly then the changes would occur if there is a grace period for a lease or if the lease payments increase in subsequent years then the lease still has to be converted to a straight-line method. As an example, in the above operating lease a company enters in to a \$60,000 five year lease but in the first year no payments are due, in the second year payments due are \$500 per month, and in years three through five payments due are \$1500 per month. To account for the difference though the lessee would have to put the payments in to a liability account to account for the difference in the straight-line method as shown in the first example.

Response #4

In simplest terms, an operating lease is a short-term agreement for the temporary rental of an asset (think Hertz rental cars for vacation). As a result, accounting for an operating lease is fairly straightforward. Under the terms of an operating lease, the lessee merely makes periodic payments to the lessor in return for the use of the asset. The lessee recognizes these periodic payments in equal installments as an expense over the period of the lease. The lease is charged on a straight line basis over the lease term even if the lessee makes actual payments on a different basis (i.e. weekly instead of monthly). The lease rental payment is written off in the profit and loss account due to the lessee incurring an operating expense. Finally, the lessee has to disclose in the notes to the accounts the amount charged in the year and the amount of the payments has been committed at the year end.