

Week 5 - DQ 2

What are the criteria for classifying a lease as operating or capital?

Why is there a difference between the two?

What are the implications of an operating lease versus a capital lease on an entity's financial statements?

Response #1 The criteria and characteristics of operating lease is that operating lease usually a shorter-term lease under which the lessor is responsible for insurance, taxes, and upkeep. An operating lease maybe canceled by the lessee on short notice. The criteria and characteristics of capital lease is that capital lease is typically a longer-term, fully amortized lease under which the lessee is responsible for maintenance, taxes, and insurance. A capital lease is usually not cancelable by the lessee without penalty. To distinguish between the financial lease and the operating lease on financial statement, let's consider the following example. An organization has \$90,000 in assets and no debt, which implies that the equity is also \$90,000. The company needs new computers costing \$90,000 that can lease or buy. Financial leases are often called capital leases by the accountants.

If the lease is a capital lease, then the computers are shown as an asset and the present value of the lease payments is shown as a liability. Here is how the balance sheet looks like with capital lease or financial lease:

Assets under capital lease	\$90,000	Obligations under capital lease	\$90,000
Other assets	\$90,000	Equity	\$90,000
Total assets	\$180,000	Total debt plus equity	\$180,000

If lease is an operating lease, then neither the asset (the computers) nor the liability (the present value of the lease payments) appears. Here is how the balance sheet looks like with operating lease:

Computers	\$0	Debt	\$0
Other Assets	\$90,000	Equity	\$90,000
Total assets	\$90,000	Total debt plus equity	\$90,000

Response #2 Capitalization criteria (lessee)

- A lease is classified as a capital lease if one or more of the following is met :
- The lease transfer ownership of the property to the lessee.
- The lease contains a bargain purchase option
- The lease term is equal to 75 percent or more of the estimated economic life of the leased property.

The present value of the minimum lease payments (excluding executory costs) equals or exceeds 90 percent of the fair value of the leased property.

The difference between the two are capital leases are similar to installment purchases, capitalize all long term leases, a final approach advocates capitalizing only "firm" (no cancelable) contractual rights and obligations. "Firm" means that it is unlikely to avoid performance under the lease without a severe penalty.

The implications of an operating lease versus a capital lease on an entity's financial statement companies do not capitalize operating leases instead companies should account for them as rental payments and receipts. Under the capital lease method a company, treats the lease transaction as if it purchases the financing transaction, it records a capital lease as an asset and liability.

Response #3 The criteria for classifying a lease as a capital lease when one or more of the following are met. Transfer the ownership of property to the lessee, the lease has a bargain purchase option, lease term is 75% or more of the estimated economic life and the minimum lease payment is equal or exceeds 90% of fair market value. The difference between the two is capital leases are recorded as an asset and liability and an operating lease is an expense. The implications of an operating lease versus a capital lease on an entity's financial statements includes the operating lease recognizes the costs with each payment and a capital lease can be depreciated over its useful life.

Response #4 In order for a lease to be considered capital it must meet at least one of four criteria:

- The ownership would be transferred to the lessee at the end of the lease
- The lessee will have the opportunity to purchase the asset
- The term of the lease is equal to or more than 75% of the estimated life of the asset.
- The total of the payments made are equal or are over 90% of fair market value.

There is a difference between the two because assets and liabilities are treated differently. Depending upon the aforementioned criteria the asset and its lease are treated accordingly.

Net income as well as different tax advantages would be impacted on a company's financial statements. Capital leases are shown as assets while the value is offset as a liability.