

Week 5 - DQ 4

What are the advantages of operating and capital leases? What are the disadvantages?

Why would a company pick one over the other?

Response #1 A couple of advantages of operating leases: can be for short periods of time and the risk is shifted from the lessee to the lessor. A couple of advantages of capital leases are: evidence of the lease on the balance sheet of the lessee and option to purchase at the end of end of the lease.

A company may choose to utilize an operating lease over a capital lease when they do not wish to own the asset at the end of the lease. I think I read somewhere that the company can write off the monthly lease payments if they use the operating lease. But with the capital lease I think the IRS only allows a write-off up to \$135,000 (or an amount close to that). That would be a huge deciding factor - the money saved and supplemented by the revenue that the lease assists in obtaining can be quite a boost to the net income of a company.

Response #2 An operating lease is normally for a shorter amount of time so the organizations risk is low. A disadvantage of a operating lease is that the organization does not own the equipment after the lease term is up. That could be an advantage though. If an organization is in a line of business in which specialized equipment becomes obsolete quickly, then the ability to merely "rent" (enter into an operating lease) the equipment would be beneficial.

Response #3 Advantages of capital leases include the tax benefits. You can deduct the tax on the lease payments and depreciation. Advantages of capital leases include deduction of the lease payments and any related costs. Disadvantages with a capital lease include no deduction for the lease payments and taxes have to be paid on the property. A company would pick one over the other depending on how much they want to spend at the time and how the cash flow is within the company.

Response #4 Advantages of an operating lease are less debt both short-term and long-term and higher income early in life, which results in higher retained earnings. A disadvantage of an operating lease is not as many assets. Advantages of a capital lease are lower charges in later years, less debt, and more total assets. It depends on whether the company is the lessee or the lessor. Depreciation and capitalization of the asset also plays a role on a company's decision. Wanting to own the leased asset at the end of the term is another factor in the decision.