Lease

Leases The Big Bear Company has posted strong financial results for many years and has a positive cash flow. The Company has entered into a 10 year lease agreement with Goliath Co for a combustion turbine on December 15, 2004 which has become operational since January 1, 2005. This report assesses certain costs incurred in connection with the lease agreement, in order to determine whether or not they would fall within the provisions of the “ minimum lease payments” provision in FASB Statement no: 13.

Under the lease classification criteria set out under the FSAB standards, the lease agreement is for the use of the combustion turbine which could qualify as a capital lease because it is an agreement for the use of a piece of property that could be classified as an asset. The first item to be assessed is the legal fees arising in connection with the lease, i. e., $500K to Stipe, Berry, Mills and Buck, together with $1 million in legal fees incurred by Goliath Co. These expenses would fall under the category of external expenses that are not incurred on a sustained basis, but rather are a one-off expense. They do not fall under the category of a recurring expense and moreover, the total value of the payments as mentioned above, is unlikely to add up to a sum that is greater than 90% of the fair value of the leased asset, i. e., the combustion turbine. This expense can however be included in the Balance sheet of the Company as an establishment expense, which would fall under the category of a one-time expense for setting up the lease. The advantage of this method is that it could contribute towards the payment of lower taxes to be paid on incomes gained from the leased property during the first year of lease.

In regard to the second provision, the lease is a capital lease that would fall under the category of a direct financing lease, because lease payments are being made by a bank and Goliath Company which is leasing out the asset does not gain any share in the profits of Big Bear. The default provision in the lease requires a penalty payment from Big Bear if there is a “ material adverse change” in its financial condition. Although this term is not specifically defined under the agreement, nevertheless the direct inference would be construed as any change in financial circumstances that lead to Big Bear being unable to make its payments. The inclusion of a penalty payment is a fairly standard provision within a lease document, but the instigating factor is a default in the bank’s credit arrangement. This would fall partially within the purview of the minimum lease payments provisions, because the penalty amount would become payable when there is a default in the minimum lease payments that must be made. It is however, unlikely that this provision would satisfy the proviso of being greater than 90% of the value of the asset. An alternative would be to adequately define adverse material change, so that there is a greater clarity in what exactly would constitute such a change in financial condition. The advantage would be that the specific conditions when penalties are payable would become clearer. According to the lease agreement, Big Bear’s rental payments are to be an amount of $1 million increased by 4%, which is the current increase in the Consumer Price Index. This amounts to a total of $1 million and 400, 000 approximately. Under Topic 840 of FASB Statement 13, accounting items that could be included within this classification include the application of the 90% rule, wherein the present value of the minimum lease payments is greater than 90% of the fair value of the leased property. In this connection, the relevant factor would be the total price of the combustion engine that has been agreed upon in the agreement. If the sum of $1 million and 400, 000 exceeds or is equal to 70% or 90% of the total lease amount, then it could satisfy wholly, the requirements of the minimum lease payments. In the agreement, the period for assessment of CPI has been clearly set out, as well as the time frames when payments would become due and payable. An alternative would be to clearly specify a definite amount for the lease payment every month and add a marginal amount by which it would increase every year between specified time frames. This would ensure that the lease amounts would always be clear and there would be no ambivalence in determining minimum lease payments.

References:

US GAAP Codification of Accounting Standards. Retrieved March 9, 2010 from: http://accountinginfo. com/financial-accounting-standards/asc-800/840-30-capital-leases. htm