

Big bear power essay sample

[Economics](#), [Consumer](#)



Big Bear Power (Big Bear) is a widely held public utility company that has posted strong financial results for several years. Big Bear has positive cash flow, and it is in compliance with all its debt covenants. Big Bear leases a combustion turbine from Goliath Co. (Goliath) for a 10-year non-cancelable term. The lease agreement is signed on December 15, 2010, and Big Bear's right to use the turbine begins on January 1, 2011. Various provisions and other facts from the lease are listed below.

Provision 1

Big Bear pays Stipe, Berry, Mills and Buck LLP, its external legal counsel, \$500, 000 in connection with negotiating the lease agreement. Big Bear is also required to pay \$1 million of legal fees incurred by Goliath.

For Provision 1, our group thinks that the external legal counsel \$500, 000 should be excluded from minimum lease payments, and \$1 million of legal fees paid by Big Bear should be included in minimum lease payments.

According to ASC 840-10-25-5, it says “ For a lessee, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, excluding both of the following: a. Contingent rentals

b. Any guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.”

The nature of the legal counseling fee \$500, 000 is similar to the executory cost—to make sure the whole process of the lease legally, just like paying

taxes or buying insurance to avoid trouble from government and keep things work legally. This legal counseling fee is paid directly to the external legal counsel firm (the third party). The fee has nothing to do with the lessor and it is not an obligatory payment for lessee to be made toward the property leased. Additionally, this legal counseling fee does not match any of the 5 components of minimum lease payments, described in ASC 840-10-25-6. Therefore, the legal counseling fee \$500, 000 paid to Stipe, Berry, Mills and Buck LLP should be expensed when incurred and not be included in minimum lease payments.

But this will lead to the decrease of minimum lease payment. There are two reasons that we think minimum lease payment should not be decreased. First, from the given information in the case we can only infer that Big Bear pays the legal fee for Goliath is to offset part of the lease payments. If the payment of 1 million is to offset part of the lease payments, including 1 million in the minimum lease payment would more accurately reflect the value of the lease. Second, the decrease of the minimum lease payment may lead Big Bear to fail the 90% test (the present value of the minimum lease payments is larger than 90% of the asset's fair value at lease inception). Based on first reason, if the minimum lease payments do not accurately reflect the value of the lease, the test will not get a faithful result. Chances are that Big Bear does not have to capitalize the lease when it is supposed to do so, which results in unfaithful representation of liability. So, it is reasonable to include 1 million in the minimum lease payment.

Provision 2

The stated default provisions in the lease stipulate that Big Bear must purchase the combustion turbine from Goliath (at a price equal to the remaining lease payments) within 30 days if a “ change in control” event occurs. Additionally, Big Bear would be required to pay a penalty of \$500,000. A “ change in control” event is defined under the lease as either (1) a situation in which a person or entity becomes the beneficial owner, directly or indirectly, of 50 percent or more of the outstanding voting shares of Big Bear or (2) a situation in which Big Bear merges with another entity. As of the inception of the lease, Big Bear does not expect a “ change in control” event to occur during the term of the lease.

In this provision, Little Bird had to purchase the equipment from Goliath within 30 days and pay a penalty if a “ change in control” event occur. According to ASC 840-10-25-14, it is said that “ default covenants related to non-performance do not affect lease classification if all of the following conditions exist: a)The default covenant provision is customary in financing arrangements. b)The occurrence of the event of default is objectively determinable (for example, subjective acceleration clauses would not satisfy this condition). c)Predefined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default. d)It is reasonable to assume, based on the facts and circumstances that exist at lease inception, which the event of default will not occur. In applying this condition, it is expected that entities would consider recent trends in the lessee’s operations”. If any of those conditions do not exist, then the maximum amount that the lessee could be required to pay under

the default covenant shall be included in minimum lease payments for purposes of applying paragraph 840-10-25-1(d).

In this situation, we believe that the penalty of \$500, 000 should not be included in “ minimum lease payments”. Considering all information we have, we assume the default covenant is normal. Paying penalty and purchase the equipment if “ change in control” happened is reasonable to a business. Thus, we think there is no evidence provided that the default covenant is uncustomary. For condition (b) and (c), the definition of “ change in control” is prescribed precisely. One is that a situation in which “ a person or entity becomes the beneficial owner, directly or indirectly, of 50 percent or more of the outstanding voting shares of Little Bird”. The other is that Little Bird merges with another entity. If any one of these two conditions is satisfied, it is called “ change in control”. At last, it seems that Little Bird is profitable and it is less likely that “ change in control” will happened during the term of lease. Condition (d) also exists. Therefore, the payment should not be included in the minimum lease payment.

Provision 3

The lease agreement stipulates that Big Bear’s lease payments shall be \$1 million per year, payable ratably over 12 months at the beginning of each month. For each calendar year of the term of the lease after 2011, Big Bear will pay minimum rent in an amount equal to \$1 million increased (but not decreased) by the same percentage as the increase in the consumer price index (CPI) from January 1 of the prior year until January 1 of each

respective year. As of the inception of the lease, the most recent annual increase in CPI was 4 percent.

According to ASC 840-10-25-4, it says “ Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. (Example 7 [see paragraph 840-10-55-39] illustrates this guidance.)” Also, ASC 840-10-55-39 says that “ lease payments that depend on an existing index or rate, such as the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception.”

In this case, the lease payments per year depend on CPI. At the inception of the lease, the increase in the consumer price index (CPI) was 4% (the existing index at lease inception). Therefore, the present value of annual rental payment 1 million and the increase of 4% in CPI should be included in the minimum lease payment.