Leasing decision at magnet beauty products, inc

Business, Decision Making

Under the old method the leases were treated as operating leases on the books. This resulted in what can be called “ off-balance sheet” financing, because the leases were not required to be carried as assets on the balance sheet. Instead, leases showed up only through rent expense on the income statement. On the contrary, under the new method of accounting for leases, all leases are required to be carried as capital leases. This affects both the balance sheet and the income statement together. On the balance sheet, the leases are carried as an asset (Right-to-Use) and a liability (Lease Obligation). Both of these are decreased through amortization expenses that hit the income statement. In addition to the amortization expense recognized in the income statement, we also see interest expense due to the amortization process of the Lease Obligation. Financial StatementAnalysis

First off, when we look at the old method, the rent expense hits the income statement above the line and affects EBITDA (Operating Income). Whereas, in the new method we see the expenses as Depreciation/Amortization and Interest Expense, which occur below EBITDA to arrive at Net Income. On the Cash Flow Statement, the operating lease affects Cash Flow from Operating Activities, while the capital lease affects the Cash Flow from Financing Activities. Ultimately, these differences do not affect the cash flow in aggregate. However, they do change the make-up of the Cash Flow Statement due to different uses in various activities. Ratios

Return on Assets (Net Income/Avg. Total Assets) In the “ 3 plus 2 year lease” the new method causes the Return on Assets ratio to decrease by multiple percentage points. This is due to the fact that the leases are now a capitalized asset, increasing our Total Assets as a whole. In the “ five 1-year leases” both methods create the same ratio percentage. This is due to the leases being exhausted through depreciation in the only year of use. Therefore, they wash out and the asset that was carried on the books is essentially eliminated. Debt to Assets (Total Liabilities/Total Assets)

In the “ 3 plus 2 year lease” the new method causes the Return on Assets ratio to increase by several percentage points. This is due to the fact that the leases increase both the assets and liabilities in a proportionate manner, thereby increasing the total percentage of liabilities to assets. It also has a greater effect on the ratios in the earlier years when accumulated amortization/depreciation is lower. In the final year of the lease, there is no difference, because the asset and liabilities are fully exhausted. In the “ five 1-year leases” it is similar to the effect in the Return on Assets ratio. Both methods create the same ratio percentage due to the leases being exhausted through depreciation in the only year of use. Therefore, they wash out and the asset that was carried on the books is essentially eliminated. Earnings per Share (Net Income/Total Outstanding Shares)

This calculation would provide for a good analysis, but the case does not allow for it. There are no outstanding shares referenced. Instead, we calculated the change in Net Income between the two methods to see the affect it would have on at least one of the variables. In the “ 3 plus 2 year lease” the old method essentially overstates Net Income compared to the new method by 271% in the first year, down to 10% in the fifth year. This is because the only expense incurred in the operating leases deal with rent. In the “ five 1-year leases” both methods display the same Net Income. This is because the 1-year lease acts in the same manner as rent expense.

Recommendation

We recommend that Ms. Janette Clark, of Magnet Beauty Products Inc., take on the five 1-year leases. Although this will ultimately increase the lease payments, it will also overstate the Net Income of her business. This will help her attain higher quality loans from banks and be more attractive to the investment community. Although footnotes will be disclosed allowing analysts to recompute her financial statements as though the leases had been classified as a long-term capital lease, the average user would not go through the effort.