The bear minimum

Business, Accounting

Per your request, our group conducted research to determine whether costs or potential costs of the provisions of Big Bear Power's lease of Goliath Co's combustion turbine should be included in its minimum lease payments. We have provided a summary of the facts, our conclusion, the basis for our conclusion, and an analysis of possible alternatives to our conclusion as requested. Summary of the Facts Big Bear Power (the Company), a public utility company, is leasing a combustion turbine from Goliath Co. for a 10-year, non-cancelable term.

The lease agreement was signed on December 15, 2004, and the company's right to use the turbine starts on January 1, 2005. Big Bear Power has been financially strong for a number of years, has positive cash flow, and is in accordance with all of its debt covenants. The lease agreement contains three provisions, each of which has associated costs that may potentially need to be included in the calculation of minimum lease payments. The issue at hand is determining whether the costs in these provisions should, in fact, be included in minimum lease payments

Conclusion Provision 1 Big Bear Power should not include the $500, 000 negotiation fee in its minimum lease payments because, by definition, it is not an obligatory payment to be made toward the asset. On the other hand, the Company should include the $1 million legal fee in minimum lease payments since it is considered an initial direct cost made in connection with the leased property. Provision 2 The lease agreement includes a provision requiring a penalty payment if Big Bear's bank declares it in default under its primary credit arrangement.

This potential cost should be included in calculating minimum lease payments since a lack of predetermined criteria exists to determine default. Provision 3 The lease agreement stipulates Big Bear's annual lease amount to be increased by the percentage increase in the Consumer Price Index (CPI). Because the lease payments depend on the index, it must be included in the calculation of the minimum lease payment at the inception of the lease agreement. Basis for Conclusion Provision 1

In the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) 840-10-25-5, minimum lease payments are " the payments that the lessee is obligated to make or can be required to make in connection with the leased property," excluding contingent rentals, any guarantees of the lessor's debt, and executory costs. Although negotiating fees incurred by Big Bear Power are not executory costs, the fees toward its external legal counsel are considered non-obligatory in nature and should be expensed. In contrast, legal fees paid by Big Bear Power on behalf of Goliath Co. an be categorized as initial direct costs under Statement of Financial Accounting Standards (SFAS) 91. Being defined as such, they can be included in the general description of payments they are obligated to make in connection with the lease agreement. Provision 2 Big Bear Power is subject to default if there is a " material adverse change" in its financial condition. FASB ASC 840-10-25-14 provides guidance for default covenants relating to nonperformance and provides four conditions as follows: a. The default covenant provision is customary in leasing arrangements. b.

The occurrence of the event of default is objectively determinable. c. Predefined criteria, related solely to the lessee and its operations, has 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, that 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. The Codification states that if the lease agreement fails to meet all of these conditions, Big Bear Power must include the penalty in its minimum lease payments.

As already stated in the information provided, condition (a) is met. Upon further analysis, condition (b) and (d) are also met—Big Bear’s bank is an objective third-party that will determine an occurrence of default, and Big Bear Power is financially strong with remote likelihood of default. While the facts imply that “ material adverse change” is a predefined criterion to determine default, it is our contention that the lack of definition in the documents is sufficient evidence to not fulfill the third condition.

Furthermore, the absence of a definition implies a lack of objectivity within the criteria; the phrase “ material adverse change” provides no verifiable benchmark to which Big Bear Power can be examined through its operations, as mandated by the condition. Consequently, Big Bear Power should add the maximum amount of the penalty to the minimum lease payments. Provision 3 According to FASB ASC 840-10-25-4, the portion of lease payments that depends on an index, such as the Consumer Price Index(CPI), should be included in calculating minimum lease payments at lease inception.

Big Bear's lease payments are contingent on increases in the CPI, therefore it must follow this rule. The lease agreement states that Big Bear will pay $1 million per year, and the lease amount will change at each year-end by the increase in the index rate. Only the most recent CPI increase at inception will be included in minimum lease payments. Future increases in the index will not be included as they are considered a contingent rental. Analysis of Alternatives Provision 1 Alternative A debate of Provision 1 suggests that Big Bear Power should not include the $1 million in legal fees toward minimum lease payments.

Initial direct costs may be considered transactions separate from the lease itself with benefits being realized at the time of exchange (International Accounting Standards Board [IASB], 2009). Their recognition as assets would be erroneous under this premise, and instead would require an immediate expense to the income statement. Still, it remains our team's recommendation that the $1 million legal fees be treated as described, in accordance with the FASB's logic behind fees closely-tied to a lease agreement. Provision 2 Alternative

It can be contended that the required penalty payment under a declaration of default should not be included in the minimum lease payments. As stated, FASB ASC 840-10-25-14 provides four conditions, which, if all fulfilled, would not include the penalty in minimum lease payments. Based on those facts provided, and regardless of the definition behind " material adverse change", it is arguable that a sufficient criterion exists to determine default.

Furthermore, the criterion is established by a third-party with no relation to Goliath Company.

This would fulfill condition (c). Provision 3 Alternative Alternative treatment of this provision would adjust minimum lease payments annually after 2005 for the annual increase in the Consumer Price Index. For example, if the lease payment in 2005 is $1 million and the most recent CPI increases by 4%, the lease payment would increase to $1, 040, 000 in 2006, and $1, 081, 600 in 2007. The reasoning for this approach is to more accurately measure the lease agreement for financial reporting.

However, this method is not in agreement with FASB ASC 840-10-25-4, which states a lease dependent on an index should only include the index existing at lease inception when calculating minimum lease payments. References Financial Accounting Standards Board. (n. d.). Accounting standards codification. Norwalk, CT: Financial Accounting Standards Board. Retrieved February 8, 2010. International Accounting Standards Board. (2009). IASB staff paper: leases – initial direct costs. London, United Kingdom: International Accounting Standards Board. Retrieved February 8, 2010.