Essay on lease financing is better than the purchasing option

Business, Company

Introduction

A lease is a common financing instrument used by companies in different industries. There is the purchasing option however the leasing option is better as it has more advantages. In this paper, I will show the benefits of a lease agreement and why it is preferable to the purchasing option.

Lease Agreements

The Financial Accounting Standards Board describes a lease as an agreement for the lessee to use the asset of the lessor for a specified period of time. It is the right to use another company's plant, property and equipment. It is an agreement where the business owner pays an amount of money regularly to the owner of the assets for the use of the assets. In the treatment of leases, the accounting body excluded the lease agreements that concern the exploration or extraction of minerals, gas, oils and timber. It also excludes the agreements for services such as patents, motion picture films, manuscripts and copyrights.

Advantages of a Lease Agreement

A business may not have the financial capability to buy the asset but has to use the asset in the production of its products. Leasing is a cheaper option. A business may also have the financial capability to buy the asset however it does not want to commit itself due to changes in technology. If the technology changes, the business simply starts leasing the preferred asset instead of selling its asset in order to buy another one. The company does not want to tie its financial resources in fixed assets. It would rather commit

the funds to more profitable uses or buy modern technology at a later date. Selling an old asset and buying modern equipment usually takes time especially the approval and the disbursement process (Tripathy, 2004)

The company is also able to know and plan as it knows the cash flows to be

paid out by the company on payment of rental payments. It is also better to lease out assets at today’s prices rather than buying them at a later time where the prices will be higher due to inflation. The lessee gets to use the asset although he has no ownership of the asset.

Disadvantages of a Lease Agreement.

There are certain drawbacks associated with lease agreements. In the real estate industry, if the value of the asset increases, the lessee does not gain at all from the capital gain. There are also no tax incentives in an operating lease such as depreciation. The lessee does not get to own the asset when it comes to an operating lease. The interest payments paid on a lease are usually at a higher rate than the usual debt instruments. There are miscellaneous costs that have to be borne by the lessee when it comes to a capital lease. The disadvantages of taking a lease however are few and not comparable as to the benefits as highlighted above.

Types of Lease Agreements

A lease agreement is similar to debt instruments where the business pays interest payments to the asset owner. There are two types of leases, that is the capital lease and the operating lease.

Capital Lease

In a capital lease, the title of the asset moves to the lessee after the term period of the lease. The benefit of a capital lease is that it is considered as an asset of the business and the business is allowed to depreciate the assets in the financial statements. The Financial Accounting

Standards Board has laid out the conditions that have to be met before a lease agreement can be considered as a capital lease. The lease term should exceed 75% of the life of the asset. The title of the asset must be transferred to the lessee. There should also be an option for the lessee to be able to purchase the asset at the end of the lease term if he desires to do so. The other condition that should also be met is that the present value of the lease payments should be higher than 90% of the value of the asset at the prevailing market price (Robinson, Greuning, Henry, & Broihahn, 2008). The lease payments should be discounted using an appropriate discount rate.

The business enjoys some of the benefits of ownership of the asset and at the same time takes up the risks of ownership. In a capital lease, the lease is shown as both an asset and a liability. The interest payments on the lease are shown on the liability side. In a capital lease, where the benefits and risks of ownership are transferred substantially to the lessee, the capital lease can be categorized as a sales-type lease, leveraged lease or direct financing lease. In a sales-type lease, the fair value of the lease is different from the carrying amount in the financial statements. This type of lease is usually in the real estate industry. For a lease to qualify as a sales-back and it is not in the real estate industry, there are two criteria that it must meet in

addition to the four requirements specified by the Financial Accounting Standards Body. The collectability of the minimum lease payments should be predictable by the company.

Secondly, the lessor should know the unreimbursable costs that he will occur on behalf of the lease agreement. There should be no uncertainty when it comes to the amount of these costs.
Where the fair value amount of the lease is the same as the carrying amount, the lease is known as a direct-financing lease. Where the lease is in the real estate category and it meets the additional two criteria, the lease will be known as leveraged lease. A lease can be cancellable or a non-cancellable lease. In a cancellable lease, the lessor or lessee has the right to terminate the lease agreement. However, a non-cancellable lease cannot be terminated before the term period has been reached.

Operating Lease

In this type of lease, the title does not pass to the lessee. In an operating lease, the lease payments that the business pays to the owner are considered as part of operating expenses. The owner returns the asset to the owner at the end of the lease period. The business does not take up any risk on the ownership of the asset. In a capital lease, the lease is shown as part of the company’s assets however for the operating lease; they are not part of the assets.

Sale and Lease-Back

There are also other kinds of lease agreements such as sales and lease back. In this type of lease, the company sells its assets to the company then immediately leases the asset from the new owner. The company will receive the sales proceeds and immediately start paying rental amounts to the new owner (Ross, Westerfield & Jordan, 2006)

Executory Costs

The miscellaneous costs incurred by the lessee during the lease term are known as

executory costs. These are costs for insurance, maintenance and taxes. These costs may be paid by the lessor or the lessee depending on how the contract has been written. In capital leases since the risks and benefits of ownership have been passed to the lessee, the lessee is the one who pays for these executory costs. Where the lessor pays for the executory costs, he will add the costs to the periodic lease payments. These costs are therefore subtracted from the minimum lease payments since this part accounts for the reimbursement by the lessee to the lessor for the payment of the executory costs (Nikolai, Bazley, J & Jones, 2009).

The accounting standards specify that the executory costs should be subtracted from the minimum lease payments in determining the 90% value in order to classify the lease either as an operating lease or a capital lease. The lessee should therefore be able to estimate these executory costs. The accounting standards also clarify that the estimation of the insurance, taxes

and maintenance costs cannot be taken to be an important uncertainty when it comes to the determination of the lessee unreimbursable amounts in connection to the lease. An item that would fall in the category of an important uncertainty concerning the unreimbursable amounts would be product performance guarantees.

The executory expenses should be reported separately as a deduction from the minimum lease payments. The accounting standards have state that the amounts paid in consideration for a guarantee by an unrelated party are executory costs and they should therefore be excluded from the minimum lease payments. There are also instances where the lessee may lease out the asset to a new lessee. This will make the lessor, the sub lessor and the new lessee the sub lessee or the subtenant. When it comes to executory costs, the accounting standards state that where the executory costs and the rental payments exceed the anticipated revenues of the sublease, the sub lessor should record a loss in the financial statements.

The Residual Value

The residual value is defined as the future value of an asset after consideration of the depreciation of the asset based on the initial value of the asset. This is a term that is used commonly when it comes to car leases. It refers to the amount that the owners of the asset expect to sell the asset at the end of its useful life. The residual value of an asset has a relationship to the asset payments during the life of the asset. If the residual value of the asset is high, the payments will be lower and vice versa.

Accounting Treatment for Leases

Accounting for leases will be better illustrated by the use of an example. Malone enterprises leased a mainframe computer to Abe Limited on December 31, 2010. The lessee is expected to pay annual payments of $10, 000 for ten years. The first payment for Abe Computers is expected to be in December 31, 2011. The rate of interest for the lease has been set at 14%. Assuming that the lease meets all the criteria requirements for a capital lease, the company will record the present value of the future cash flows. Examining the annuity table, the discount factor at 10 years at the rate of 14% has been given as 5. 2161. The company will multiply the annual amounts with the discount factor to get the present value of the payments.

The entries in the financial statements will be recorded as follows:

2011 December, 2011

Leased Computer………………………………………………………52, 161

Lease Liability…………………………………………………………………… 52, 161

(Leased Computer from Malone Enterprises for $ 10, 000 a year for 10 years. The Discount factor at 14% = $10, 000*5. 2161)

The lessor, Malone Enterprises on the other hand will record the leased asset in the balance sheet in the section for plant, property and equipment and lease liability in the liabilities section.

Abe limited has to determine the amount of the lease interest by multiplying the interest rate to the annual payments. In the above scenario, the interest

payments will be 14% multiplied by the amount $52, 161 to give $7, 303. This accounting is a similar treatment given to mortgage payments by a bank or other financial company. The amount of the interest is calculated to determine the amount that will be used to reduce the principle balance. The first lease payment will therefore be recorded as follows in the financial statements:

2011 December, 2011

Interest Expense……………………………………………………………7, 303

Lease Liability……………………………………………………………... 2, 697

Cash……………………………………………………………………………………… 10, 000

(Annual lease payments paid = 52, 161*14%= 7, 303. 10, 000-7, 303= 2, 697)

The company in the next subsequent year, 2012, will record the value of the lease account balance as the principle less the lease liability. In the next nine years, the business will make similar entries in the financial statements. The amount of the principle will be increasing while the lease interest payments will be decreasing. This is because the interest rate is being applied on a decreasing principle amount (Albrecht, Stice, & Stice, 2010).

The benefits and tax advantages mentioned above in the capital lease support the argument that a lease is better than the financing option. The business funds are not tied up in fixed assets and the business ends up using the latest technology equipment.

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