

Corporate accounting – part 1 lease essay

Finance



STATE HOW BOTH COMPANIES SHOULD CLASSIFY THE LEASE. GIVE REASONS FOR YOUR ANSWER. Both Purple Ltd and Lemon Ltd should classify the lease as a finance lease based on the below. Present value of all future lease payments = $(\$8,000 - \$1,000) \times 3.8897 = \$27,228$ Present value of guaranteed residual value = $50\% \times 7,200 \times 0.6499$ Total present value = $\$27,228 + \$2,340$ of the Bulldozer The present value of the minimum lease payments is substantially all of the fair value of the leased asset at the inception of the lease.

Lemon Ltd can cancel the lease provided that it pays a penalty equal to 50% of the total lease payment to Purple Ltd. Lemon Ltd also guaranteed 50% of the residual value of the D9 bulldozer at the end of the lease term, should there be gains or losses from the fluctuation in the fair value of the residual. Lastly, the D9 bulldozer is not likely to be used by anyone else other than Lemon Ltd.

PREPARE A SCHEDULE OF LEASE PAYMENTS FOR LEMON LTD. Includes bargain purchase option. Note: There is a rounding error of \$1.

PREPARE A SCHEDULE OF LEASE PAYMENTS FOR PURPLE LTD. Note: There is a rounding error of \$1. JOURNAL ENTRIES For Lemon Ltd: (Depreciation expense = $[\$29,568 - \$3,600] / 5 \text{ years} = \$5,194$) For Purple Ltd: (Net Method) For Purple Ltd: (Gross Method) FINANCIAL STATEMENTS OF BOTH COMPANIES FOR YEAR ENDING 30 JUNE 2009 Lemon Ltd Extract of Financial Statement Note 5: Fees for finance lease Lemon Ltd lease D9 bulldozer under a 5 years finance lease agreement. Future minimum lease payments fall due as follows: Purple Ltd Extract of Financial Statement Note 5: Fees for

finance lease The gross investment and the present value of minimum lease payments for Purple Ltd fall due as follows: REPORT Explain the difference between a finance lease and an operating lease. A finance lease enables a company to finance the purchase of an asset, even though it is never acquired by the company. This allows the lessee to take control over an asset for a large proportion of the asset's useful life, giving them the benefits and risks of ownership. On the other hand, an operating lease is commonly used to acquire equipment on a relatively short term basis, as compared to the useful life of the asset or piece of equipment being leased.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership (AASB 117, p8). All other leases are classified as operating leases. A finance lease is to be capitalised, whereas an operating lease is not capitalised. Classification is made at the inception of the lease. Whether a lease is a finance lease or operating lease depends on the substance of the transaction rather than the form.

Guidelines of examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are provided for within the standard AASB 117 (paragraphs 10 to 12). The greatest difference between a finance lease and an operating lease is the effect each has on the balance sheet. Capitalising a finance lease means that both assets and liabilities (current and long term ones) in the balance sheet increase. This decreases working capital, but increases equity ratio. Similar to a bond or loan, finance lease expenses are allocated between interest expense and principal value. In a statement of cash flows, part of the lease payments are reported under operating cash flow and part of it under financing cash flow.

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Therefore, operating cash flow increases. In an operating lease, lease obligations are not recognized, therefore leverage ratios are understated and ratios of return (ROE and ROA) are overstated.

*Explain, by reference to the requirements AASB 117, why the accountant prefers *operating to finance leases. In an operating lease, the lessee does not assume the risk of ownership, the lease expense is treated as an operating expense in the income statement and the lease does not affect the balance sheet. In a finance lease, when both asset and liability increases, the debt equity ratio increases, making the company appear more risky.

Furthermore, operating leases generally recognize expenses later than finance leases. Firms prefer to keep leases off the books, and sometimes prefer to defer expenses, which explains the strong preference for operating leases. Describe three disadvantages to the company of entering into finance lease agreement.

The first disadvantage of a finance lease is that, it is usually more expensive than an outright cash purchase as the payments include finance charges.

The costs over the life of the asset are generally going to be higher than if the asset is purchased. The rental payments will need to compensate the lessor for acquisition, financing costs and lessor's retained risk of continuing ownership. The last disadvantage arises due to a commitment to property.

There is a commitment to making payments for the entire lease period even if the company may stop using the property. Most equipment leases are either non-cancellable or impose a stiff penalty for early termination.