A lease is a contract in which the owner of an asset (the lessor) conveys to another party (the lessee) the right to use that asset.

Characteristics of Leases
- The right to use the lessor's asset is granted in exchange for a fee called the lease payment.
- The lease payments are usually paid in installments.
- Leases may be long- or short-term.
- At its inception a lease agreement constitutes a mutually unperformed contract.
Current GAAP requires classification of leases as capital leases or operating leases.

Lease Classification

1. The lease transfers ownership of the asset to the lessee by the end of the lease term.

2. The lease contains a bargain purchase option.
Lease Classification

If at its inception a lease satisfies one or more of four criteria, it is classified as a capital lease.

3. The noncancelable lease term is 75% or more of the estimated economic life of the asset.

4. The present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased asset.

Leases that do not satisfy any of the four criteria are classified as operating leases.
Capital Leases

If an asset is classified as a capital lease, the lessee must record an asset and a liability equal to the present value of the minimum lease payments.
Lease payments are allocated between interest expense and principal payment using the effective interest method.

Capital Leases

Minimum Lease payments include:
- Amounts of periodic payments
- Residual value guarantees
- Amount of bargain purchase option
- Penalties for nonrenewal
- Executory costs are not included

Financial Statement Effects

Under an operating lease total expenses equal total cash flow
Under a capital lease total expense equals the sum of the interest payments and the amortization of the leased asset.
Financial Statement Effects

- Operating and capital leases give identical cumulative lifetime charges to expense.

- The timing of the expense charges differs between the two methods.
  - The capital lease approach leads to higher expense charges in the earlier years.

Lessor Accounting

For the lessor two criteria must be met to classify the lease as a capital lease.

- The lease must transfer property rights to the lessee (using the four criteria).
- The lease agreement must allow reasonably accurate estimates of lease net cash flows and their collectability.
Lessor Accounting
For the lessor capital leases may be one of two types
• A sales-type lease exists when the lessor is either the manufacturer of the leased asset or a dealer who sells the equipment
• A direct financing lease exists when the lessor is a financial institution

Sales-Type Lease
Under a sales-type lease the lessor earns profit from two sources
• Manufacturer's or dealer's profit
• Financing profit

Direct Financing Lease
Under the direct financing lease the lessor earns profit solely from financing.
Lessors' Operating Leases

Two requirements exist for a lease to be classified as a direct financing lease or a sale type lease:
- At least one of the property transfer criteria must be met.
- Both of the revenue recognition criteria must be met.

Otherwise the lease must be classified as an operating lease.

Financial Statement Effects

Operating leases and direct financing leases give identical cumulative lifetime incomes.

The timing of the income differs between the two methods.

The direct financing lease approach leads to higher income in the earlier years.

Lessors prefer direct financing leases for two reasons.

- Direct financing leases improve financial ratios.
- The direct financing method recognizes income sooner.

Footnote disclosures enable analysts to make lease comparisons.
Sales-Type Leases

- Accounting for a sales-type lease is a simple extension of the accounting for a direct financing lease.

- A sales-type lease includes the manufacturer’s or dealer’s profit in addition to financing profit.