

# Equipment Lease with Purchase Option

\*\*Disclaimer – The exposure draft received nearly 700 letters of comment through the comment period ended December 15, 2010. There is some expectation that key features of the standard will be modified as a result of constituent response. As a result, these illustrative examples will not likely be accurate or appropriate to rely upon after issuance of the final standard. We have provided these as an educational tool only and do not represent these examples to be accurate under current or future final standards. Any templates used in the examples below are for internal use only and are not available for distribution.

## Leasing Example – **Equipment Lease with Purchase Option**

### Subject:

*ABC Corporation has entered into a lease for excavation equipment.*

### Details:

#### The lease terms are as follows:

Tenant:	ABC Corporation (ABC)
Lessor:	General Properties, LLC (GP, LLC)
<b>Description:</b>	<b>5 2011 Caterpillar Scrapers</b>
Term:	<b>3 years</b>
Lease Date	November 1, 2009
Commencement Date:	January 1, 2010
Base Rental:	<b>\$10,000 monthly per unit</b>
Initial Direct Costs	ABC Corporation paid <b>delivery costs of \$9,000</b> and \$1,000 for document preparation in conjunction with the lease process
Commissions	Commissions on the lease of <b>\$0</b> are paid directly by the lessor
Security Deposit:	<b>\$0</b>
Free Rent Period:	<b>N/A</b>
Option to Extend:	<b>None</b>
% share Operating Costs:	<b>None</b>
Subletting:	Not permitted
Build Out Allowance:	<b>None</b>
Residual Value Guarantees:	<b>None</b>
Purchase Option	Predetermined <b>“market value” of equipment of \$600,000 less lease payments after initial three years of lease (\$240,000)</b>

#### Other relevant assumptions:

Incremental borrowing:	The incremental borrowing rate of ABC Corporation is 7%
Rate charged by Lessor	This rate cannot be reliably determined by the lessee, but was computed at 8% for the lessor
Likelihood of extension:	<b>None</b>
Reassessment:	Throughout the period, no reassessment of contingent rentals, residual value guarantees or impairment occur
Amortization:	The Right to Use Asset (lessee) and Lease Liability (lessor) will be amortized straight line over the life of the lease

## Comparison of Financial Statement Impact for Life of the Lease

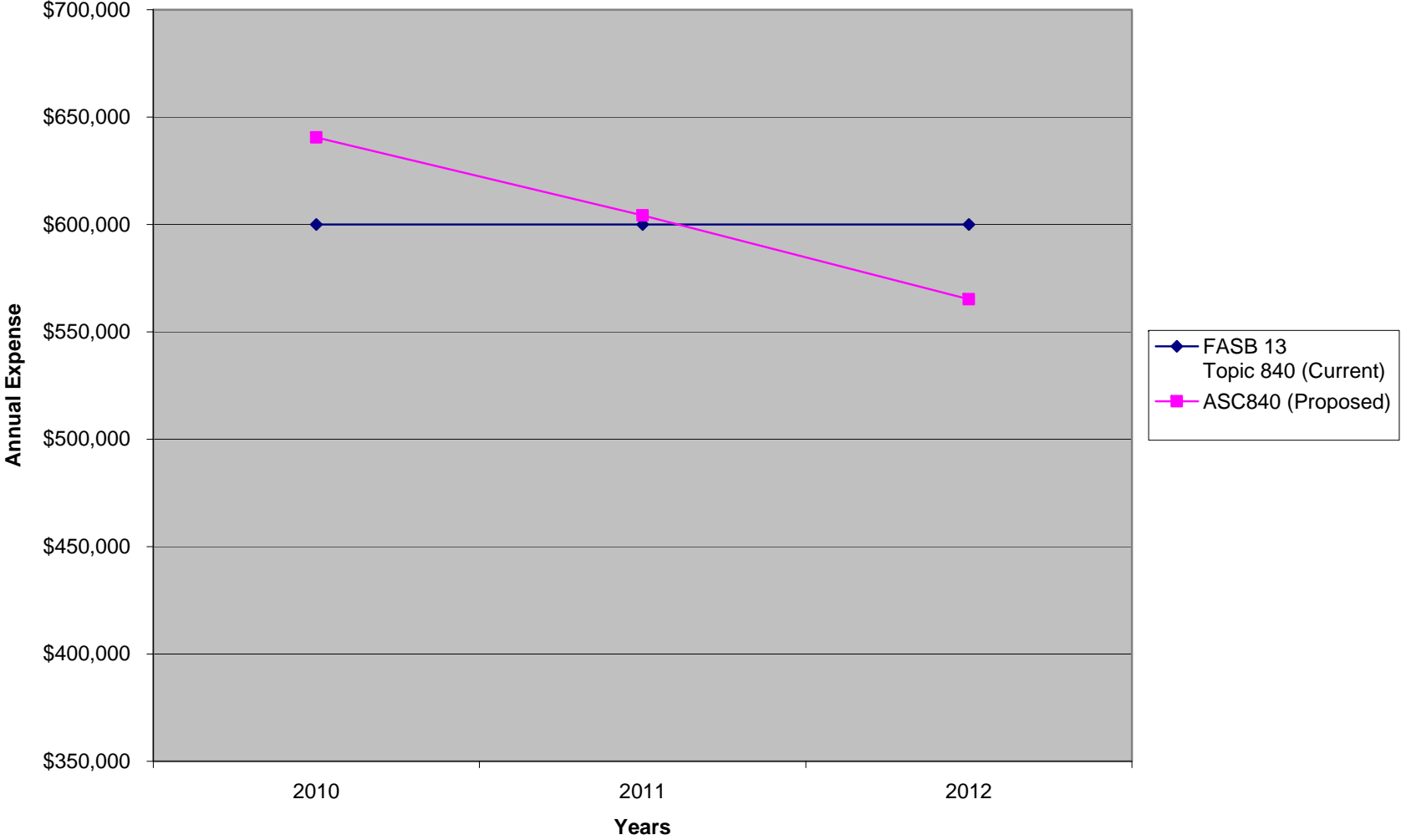
Detailed balance sheet comparisons follow, but the summary impact of key elements are listed below:

Year	Lease Expense vs. Amort / Interest		Right To Use Asset (not recorded under the current accounting requirements)		Straight Line Liab vs. Lease Liability	
	FASB 13 (Current)*	ASC840 (Proposed)*	FASB 13 (Current)	ASC840 (Proposed)	FASB 13 (Current)	ASC840 (Proposed)
2009	\$10,000	\$-	\$--	\$--	\$--	\$--
2010	<b>\$600,000</b>	<b>\$640,540</b>	\$--	<b>\$1,086,215</b>	\$--	<b>\$1,116,755</b>
2011	<b>\$600,000</b>	<b>\$604,209</b>	\$--	<b>\$543,108</b>	\$--	<b>\$577,856</b>
2012	<b>\$600,000</b>	<b>\$565,252</b>	\$--	\$--	\$--	\$--
Totals	<b>\$1,810,000</b>	<b>\$1,810,000</b>				
Average Balance			\$--	<b>\$543,108</b>	\$--	<b>\$564,870</b>

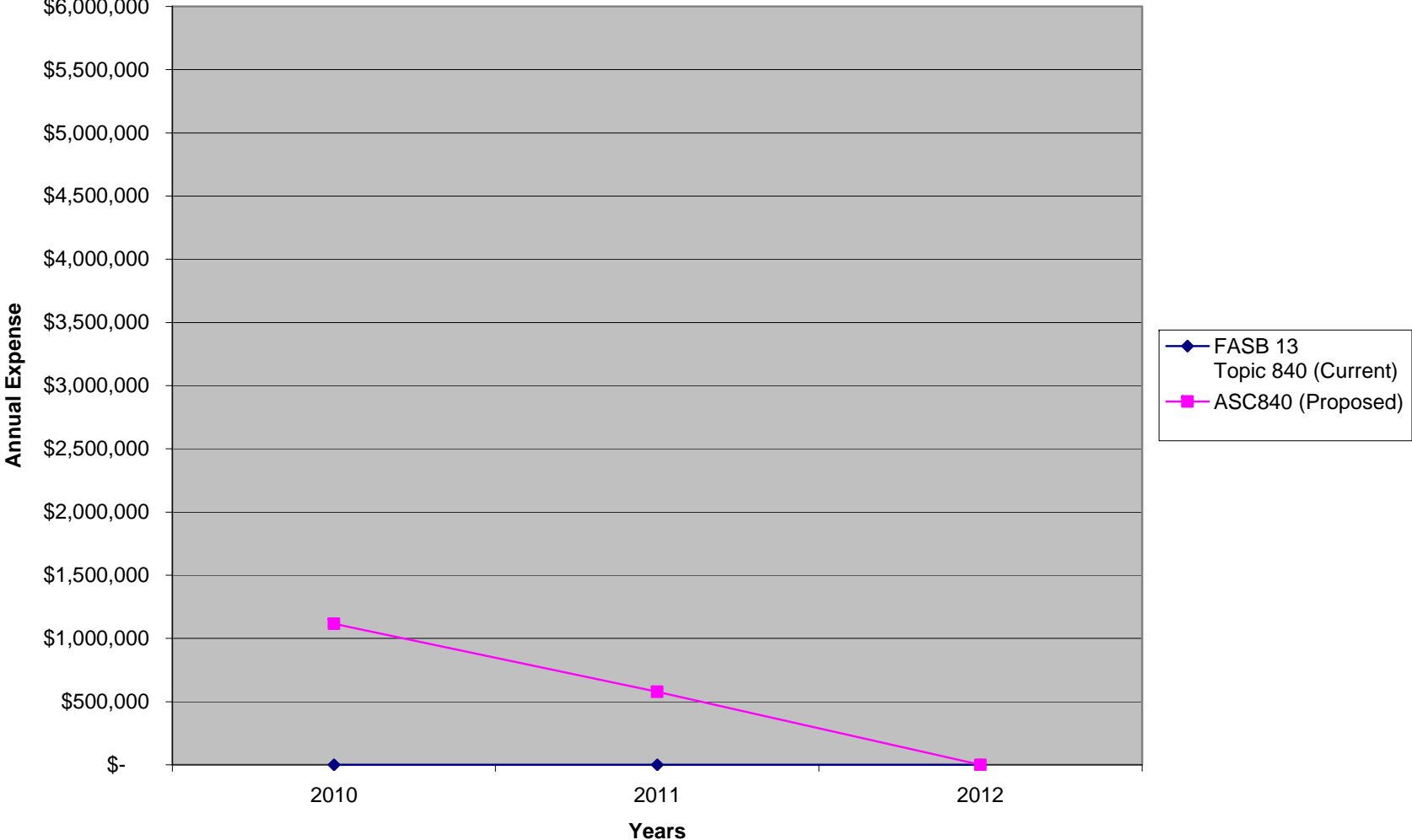
\* Excludes CAM charges and Security Deposit

**Note – the purchase option does not factor in as a lease payment.**

### Impact on Net Income



### Impact on Lease Liability



## Comparison of Financial Statement Impact for Life of the Lease – Detailed by Year

### December 31, 2010 – Initial Lease Year End

	FASB 13 (Current)		ASC840 (ED - Proposed)	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
<b>Income Statement</b>				
Operating Expense (Rent & CAM)	\$600,000		\$--	
Amortization Expense	\$--		\$543,108	
Interest Expense	\$--		\$97,432	
Impact on Net Income	\$600,000		\$640,540	
<b>Balance Sheet</b>				
<i>Assets</i>				
Security Deposit		\$--		\$--
Right to Use Asset		\$--		\$1,629,323
Accm Amort – RTU Asset		\$--		\$(543,108)
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$--		\$(1,105,527)

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

### December 31, 2011 – Second Year of Lease Term Life

	FASB 13 (Current)		ASC840 (ED - Proposed)	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
<b>Income Statement</b>				
Operating Expense (Rent & CAM)	\$600,000		\$--	
Amortization Expense	\$--		\$543,108	
Interest Expense	\$--		\$61,101	
Impact on Net Income	\$600,000		604,209	
<b>Balance Sheet</b>				
<i>Assets</i>				
Security Deposit		\$--		\$--
Right to Use Asset		\$--		\$1,629,323
Accm Amort – RTU Asset		\$--		\$(1,086,215)
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$--		\$(574,789)

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

**December 31, 2012 – End of Original Lease Term Life**

	<b>FASB 13 (Current)</b>		<b>ASC840 (ED - Proposed)</b>	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
<b>Income Statement</b>				
Operating Expense (Rent & CAM)	<b>\$600,000</b>		<b>\$--</b>	
Amortization Expense	\$--		<b>\$543,108</b>	
Interest Expense	\$--		<b>\$22,144</b>	
Impact on Net Income	<b>\$600,000</b>		<b>\$565,252</b>	
<b>Balance Sheet</b>				
<i>Assets</i>				
Security Deposit		\$--		\$--
Right to Use Asset		\$--		<b>\$1,629,323</b>
Accm Amort – RTU Asset		\$--		<b>\$(1,629,323)</b>
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$--		\$--

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

**ABC Corporation**  
**Consolidated Balance Sheet**  
**December 31, 2010**

**Assets**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Current Assets</b>		
Cash and cash equivalents	\$ 235,000	\$ 235,000
Accounts receivable, net	3,250,000	3,250,000
Inventories	5,750,000	5,750,000
Prepaid expenses and other	<u>65,000</u>	<u>65,000</u>
Total current assets	<u>9,300,000</u>	<u>9,300,000</u>
 <b>Property and Equipment, At Cost</b>		
Furniture and fixtures	345,000	345,000
Right of use assets	<u>345,000</u>	<u>1,629,323</u>
	345,000	1,974,323
Less accumulated depreciation and amortization	<u>(100,000)</u>	<u>(643,108)</u>
	<u>245,000</u>	<u>1,331,215</u>
Total assets	<u>\$ 9,545,000</u>	<u>\$ 10,631,215</u>

**Liabilities and Stockholders' Equity**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Current Liabilities</b>		
Current maturities of long-term debt	\$ 100,000	\$ 100,000
Current maturities of lease liabilities	<u>850,000</u>	<u>538,899</u>
Accounts payable and accrued expenses	<u>850,000</u>	<u>850,000</u>
Total current liabilities	<u>950,000</u>	<u>1,488,899</u>
 <b>Long-term Debt</b>		
	<u>4,000,000</u>	<u>4,000,000</u>
<b>Straight Line Lease Liability / Lease Liabilities</b>	<u>-</u>	<u>577,856</u>
 <b>Stockholders' Equity</b>		
Common stock	100,000	100,000
Retained earnings	<u>4,495,000</u>	<u>4,464,460</u>
Total stockholders' equity	<u>4,595,000</u>	<u>4,564,460</u>
Total liabilities and stockholders' equity	<u>\$ 9,545,000</u>	<u>\$ 10,631,215</u>

**ABC Corporation**  
**Consolidated Income Statement**  
**For the Year Ended December 31, 2010**

	<u>FASB 13 (Current)</u>	<u>ASC840 (Proposed)</u>
Net Sales	\$ 25,000,000	\$ 25,000,000
Cost of Goods Sold	<u>18,000,000</u>	<u>18,000,000</u>
Gross Profit	<u>7,000,000</u>	<u>7,000,000</u>
<b>Operating Expenses</b>		
Salaries	4,000,000	4,000,000
Rent expense	<b>600,000</b>	-
Depreciation and amortization	50,000	<b>593,108</b>
Other	<u>85,000</u>	<u>85,000</u>
	<u><b>4,735,000</b></u>	<u><b>4,678,108</b></u>
<b>Operating Income</b>	<u><b>2,265,000</b></u>	<u><b>2,321,892</b></u>
<b>Other Expense</b>		
Interest expense	246,000	<b>343,432</b>
Other	<u>137,000</u>	<u>137,000</u>
	<u>383,000</u>	<u><b>480,432</b></u>
<b>Net Income</b>	<u><b>\$ 1,882,000</b></u>	<u><b>\$ 1,841,460</b></u>

**ABC Corporation**  
**Consolidated Cash Flow Statement**  
**For the Year Ended December 31, 2010**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Operating Activities</b>		
Net income	\$ 1,882,000	\$ 1,841,460
Items not requiring (providing) cash		
Depreciation	50,000	50,000
Amortization of right to use assets		543,108
Changes in		
Accounts receivable	(850,000)	(850,000)
Inventories	(500,000)	(500,000)
Straight line lease liability	-	
Lease liability		97,432
Accounts payable and accrued expenses	(627,017)	(627,017)
Net cash provided by operating activities	<u>(45,017)</u>	<u>554,983</u>
<b>Investing Activities</b>		
Purchase of property and equipment	(50,000)	(50,000)
Net cash used in investing activities	<u>(50,000)</u>	<u>(50,000)</u>
<b>Financing Activities</b>		
Cash payments for leases		(600,000)
Net cash used in financing activities		<u>(600,000)</u>
<b>Increase in Cash and Cash Equivalents</b>	<b>(95,017)</b>	<b>(95,017)</b>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>330,017</b>	<b>330,017</b>
<b>Cash and Cash Equivalents, End of Year</b>	<u>\$ 235,000</u>	<u>\$ 235,000</u>
<b>Supplemental Cash Flows Information</b>		
Interest paid on long-term debt	\$ 246,000	\$ 246,000
Initial recognition of right to use asset and associated liability	\$	\$ 1,629,323

**ABC Corporation**  
**Consolidated Cash Flow Statement**  
**For the Year Ended December 31, 2010**

**Note X: Lease Accounting**

**Amounts Recognized in the Financial Statements**

The Company entered into a lease on November 1, 2009 for ~~20,000 square feet of space~~ five (5) 2011 Caterpillar Scrapers commencing on January 1, 2010 for a ~~ten-three~~ year term with ~~one optional renewal period of five years~~ a purchase option that approximates the remaining payments based on the current market value. ~~The lease includes a significant penalty for non-renewal, resulting in an assessment that the longest term more likely than not to occur is the entire 15 years, including the renewal period.~~ Attorney-Delivery fees of \$10,000 were incurred in conjunction entering the lease.

Interest expense on the income statement includes \$~~382,649~~97,432 of interest related to the lease liability, while depreciation and amortization expense includes \$~~360,748~~543,108 of amortization of the right to use asset.

The facility equipment is amortized on a straight line basis over the ~~15-3~~ year life, as this best reflects the pattern of use of the benefit of the space equipment. There are no significant limitations imposed on the Company as a result of entering this lease.

The right to use assets and liabilities to make payments changed during the period as follows:

	<b>Right to Use Asset</b>	<b>Lease Liability</b>
Beginning balance	\$ <b>0</b>	\$ <b>10,000</b>
Recognition of present value of lease payments	<b>1,629,323</b>	<b>1,629,323</b>
Amortization of the right to use asset	<b>(543,108)</b>	
Interest expense incurred on the lease liability		<b>97,432</b>
Cash payments	<u>                    </u>	<u><b>(600,000)</b></u>
Ending balance	<u>\$ <b>1,086,215</b></u>	<u>\$ <b>1,116,755</b></u>

**Lease Impact on Amount, timing and Uncertainty of Future Cash Flows**

The rate charged by the lessor for the facility equipment lease at inception was indeterminable, so the discount rate used to compute the present value of lease payments was the best estimate of the Company's incremental borrowing rate of 7%.

Future minimum lease payments, including the renewal term, at December 31, 2010, were:

2011	\$ <b>600,000</b>
2012	<u><b>600,000</b></u>
	<u><u>\$ <b>1,200,000</b></u></u>