

# Equipment Lease With a Service Component

\*\*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 a service component**

### Subject:

*ABC Corporation has entered into a lease for 10 copy machines. The agreement contains a maintenance agreement.*

### Details:

#### The lease terms are as follows:

Lessee :	ABC Corporation (ABC)
Lessor:	XYZ Rentals, LLC (XYZ)
Term:	60 months with no renewal options
Lease Date:	January 1, 2010
Commencement Date:	January 1, 2010
Monthly rental:	\$400 per copy machine (\$4,000 monthly, \$48,000 annually)
Maintenance*:	\$.006 per copy per month, minimum 5,000 copies per machine (minimum \$300 monthly)
Purchase option:	Fair market value at end of lease term

#### 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
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

\* Maintenance agreement includes any repairs, toner, staples, etc. – everything for the copier except paper.

**NOTE:** Under the exposure draft on leases, the lease agreement has a lease component and a service component. The service component is distinct because the lessor sells an identical or similar service separately. Thus, the lease component is accounted for under the exposure draft on leases while the service component is accounted for separately under the separate exposure draft on revenue from contracts with customers. For purposes of the example below, it is assumed that the monthly number of copies per machine never exceeds 5000 resulting in the minimum monthly charge always applying.

Current Accounting:

*The lease qualifies as an operating lease and would be accounted for as follows:*

Lease life cycle	Lessee Accounting		Lessor Accounting		
		Debit	Credit		Debit
<b>Initiation of the lease</b>	No required entry			No required entry	
<b>Monthly Payments</b>					
2010 (condensed)	Rent expense Maintenance expense Cash	48,000 3,600	51,600	Cash Rental income Service income	51,600 48,000 3,600
2011 (condensed)	Rent expense Maintenance expense Cash	48,000 3,600	51,600	Cash Rental income Service income	51,600 48,000 3,600
2012 (condensed)	Rent expense Maintenance expense Cash	48,000 3,600	51,600	Cash Rental income Service income	51,600 48,000 3,600
2013 (condensed)	Rent expense Maintenance expense Cash	48,000 3,600	51,600	Cash Rental income Service income	51,600 48,000 3,600
2014 (condensed)	Rent expense Maintenance expense Cash	48,000 3,600	51,600	Cash Rental income Service income	51,600 48,000 3,600
<b>Conclusion of lease</b>	No required entry			No required entry	

Revised Accounting:

*Under the exposure draft, the transactions would be accounted for as follows for the lessee and lessor:*

Lease life cycle	Lessee Accounting			Lessor Accounting		
		Debit	Credit		Debit	Credit
Initiation of the lease	Right to use asset (RTU) Lease liability	202,008		Right to receive lease pymt (RTR) Lease liability	197,274	
			202,008			197,274
<b>Monthly Payments</b>						
2010 (condensed)	Lease interest expense RTU amortization Maintenance expense Lease liability RTU Accumulated Amort Cash	13,033 40,402 3,600 34,967		Cash Lease liability amortization Service income Lease interest income Lease liab accum amortization RTR	51,600 39,455	
			40,402			3,600 14,574 39,455 33,426
			51,600			
2011 (condensed)	Lease interest expense RTU amortization Maintenance expense Lease liability RTU Accumulated Amort Cash	10,505 40,402 3,600 37,495		Cash Lease liability amortization Service income Lease interest income Lease liab accum amortization RTR	51,600 39,455	
			40,402			3,600 11,800 39,455 36,200
			51,600			
2012 (condensed)	Lease interest expense RTU amortization Maintenance expense Lease liability RTU Accumulated Amort Cash	7,794 40,402 3,600 40,206		Cash Lease liability amortization Service income Lease interest income Lease liab accum amortization RTR	51,600 39,455	
			40,402			3,600 8,795 39,455 39,205
			51,600			
2013 (condensed)	Lease interest expense RTU amortization Maintenance expense Lease liability RTU Accumulated Amort Cash	4,888 40,402 3,600 43,112		Cash Lease liability amortization Service income Lease interest income Lease liab accum amortization RTR	51,600 39,455	
			40,402			3,600 5,541 39,455 42,459
			51,600			
2014 (condensed)	Lease interest expense RTU amortization Maintenance expense Lease liability RTU Accumulated Amort Cash	1,772 40,400 3,600 46,228		Cash Lease liability amortization Service income Lease interest income Lease liab accum amortization RTR	51,600 39,454	
			40,400			3,600 2,016 39,454 45,984
			51,600			

Impact on Financials:

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

DR(CR)	Lessee		Lessor	
	Current Accounting	New Accounting	Current Accounting	New Accounting
<b>Balance Sheet</b>				
Right to Use Asset	-	202,008	-	-
Right to Receive Asset	-	-	-	163,848
Accumulated Amortization	-	(40,402)	-	39,455
Lease Liability	-	(167,041)	-	(197,274)
<b>Income Statement</b>				
Rental Income	-	-	(48,000)	-
Service Income	-	-	(3,600)	(3,600)
Interest Income	-	-	-	(14,574)
Rent Expense	48,000	-	-	-
Maintenance Expense	3,600	3,600	-	-
Amortization	-	40,402	-	(39,455)
Interest Expense	-	13,033	-	-
Net Income	51,600	57,035	(51,600)	(57,629)

**December 31, 2012 – Mid-Point of Lease Life**

DR(CR)	Lessee		Lessor	
	Current Accounting	New Accounting	Current Accounting	New Accounting
<b>Balance Sheet</b>				
Right to Use Asset	-	202,008	-	-
Right to Receive Asset	-	-	-	88,443
Accumulated Amortization	-	(121,206)	-	118,365
Lease Liability	-	(89,340)	-	(197,274)
<b>Income Statement</b>				
Rental Income	-	-	(48,000)	-
Service Income	-	-	(3,600)	(3,600)
Interest Income	-	-	-	(8,795)
Rent Expense	48,000	-	-	-
Maintenance Expense	3,600	3,600	-	-
Amortization	-	40,402	-	(39,455)
Interest Expense	-	7,794	-	-
Net Income	51,600	51,796	(51,600)	(51,850)

**December 31, 2014 – End of Lease Life**

DR(CR)	Lessee		Lessor	
	Current Accounting	New Accounting	Current Accounting	New Accounting
<b>Balance Sheet</b>				
Right to Use Asset	-	202,008	-	-
Right to Receive Asset	-	-	-	-
Accumulated Amortization	-	(202,008)	-	197,274
Lease Liability	-	-	-	197,274)
<b>Income Statement</b>	-			
Rental Income	-	-	(48,000)	-
Service Income	-	-	(3,600)	(3,600)
Interest Income	-	-	-	(2,016)
Rent Expense	48,000	-	-	-
Maintenance Expense	3,600	3,600	-	-
Amortization	-	40,400	-	(39,454)
Interest Expense	-	1,772	-	-
Net Income	51,600	45,772	(51,600)	(45,070)

**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	\$ 538,400	\$ 538,400
Accounts receivable, net	3,250,000	3,250,000
Inventories	5,750,000	5,750,000
Prepaid expenses and other	65,000	65,000
Total current assets	9,603,400	9,603,400
 <b>Property and Equipment, At Cost</b>		
Furniture and fixtures	345,000	345,000
Right of use assets	-	202,008
	345,000	547,008
Less accumulated depreciation and amortization	(100,000)	(140,402)
	245,000	406,606
Total assets	\$ 9,848,400	\$ 10,010,006

**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	-	37,495
Accounts payable and accrued expenses	850,000	850,000
Total current liabilities	950,000	987,495
<b>Long-term Debt</b>	4,000,000	4,000,000
<b>Lease Liability</b>	-	129,546
<b>Stockholders' Equity</b>		
Common stock	100,000	100,000
Retained earnings	4,798,400	4,792,965
Total stockholders' equity	4,898,400	4,892,965
Total liabilities and stockholders' equity	\$ 9,848,400	\$ 10,010,006

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

	<u>FASB 13 (Current)</u>	<u>ASC840 (Proposed)</u>
<b>Net Sales</b>	\$ 25,000,000	\$ 25,000,000
<b>Cost of Goods Sold</b>	<u>18,000,000</u>	<u>18,000,000</u>
<b>Gross Profit</b>	<u>7,000,000</u>	<u>7,000,000</u>
<b>Operating Expenses</b>		
Salaries	4,000,000	4,000,000
Rent expense	48,000	-
Maintenance expense	3,600	3,600
Depreciation and amortization	50,000	90,402
Other	<u>85,000</u>	<u>85,000</u>
	<u>4,186,600</u>	<u>4,179,002</u>
<b>Operating Income</b>	<u>2,813,400</u>	<u>2,820,998</u>
<b>Other Expense</b>		
Interest expense	246,000	259,033
Other	<u>137,000</u>	<u>137,000</u>
	<u>383,000</u>	<u>396,033</u>
<b>Net Income</b>	<u>\$ 2,430,400</u>	<u>\$ 2,424,965</u>

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

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Operating Activities</b>		
Net income	\$ 2,430,400	\$ 2,424,965
Items not requiring (providing) cash		
Depreciation	50,000	50,000
Amortization of right to use assets	-	40,402
Changes in		
Accounts receivable	(850,000)	(850,000)
Inventories	(500,000)	(500,000)
Lease liability	-	13,033
Accounts payable and accrued expenses	(627,000)	(627,000)
Net cash provided by operating activities	503,400	551,400
<b>Investing Activities</b>		
Purchase of property and equipment	(50,000)	(50,000)
Net cash used in investing activities	(50,000)	(50,000)
<b>Financing Activities</b>		
Cash payments for leases	-	(48,000)
Net cash used in financing activities	-	(48,000)
<b>Increase in Cash and Cash Equivalents</b>	453,400	453,400
<b>Cash and Cash Equivalents, Beginning of Year</b>	85,000	85,000
<b>Cash and Cash Equivalents, End of Year</b>	\$ 538,400	\$ 538,400
<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	\$ -	\$ 202,008

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

**Note X: Lease Accounting**

***Amounts Recognized in the Financial Statements***

The Company entered into a lease on January 1, 2010 for certain equipment for a five year term, with no renewal options.

Interest expense on the income statement includes \$13,033 of interest related to the lease liability, while depreciation and amortization expense includes \$40,402 of amortization of the right to use asset.

The equipment is amortized on a straight line basis over the five year life of the lease, as this best reflects the pattern of use of the benefit of the 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 year as follows:

	<b>Right to Use Asset</b>	<b>Lease Liability</b>
Beginning balance	\$ -	\$ -
Recognition of present value of lease payments	202,008	(202,008)
Amortization of the right to use asset	(40,402)	-
Interest expense incurred on the lease liability	-	(13,033)
Cash payments	-	48,000
Ending balance	\$ 161,606	\$ 167,041

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

The rate charged by the lessor for the 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 at December 31, 2010, were:

2011		\$ 48,000
2012		48,000
2013		48,000
2014		48,000
		\$ 192,000

**XYZ Rentals, LLC**  
**Consolidated Balance Sheet**  
**December 31, 2010**

**Assets**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Current Assets</b>		
Cash and cash equivalents	\$ 25,000	\$ 25,000
Accounts receivable, net	4,000	4,000
Right to receive lease payments, current	-	36,200
Inventories	5,000	5,000
Prepaid expenses and other	<u>3,000</u>	<u>3,000</u>
Total current assets	<u>37,000</u>	<u>73,200</u>
 <b>Property and Equipment, At Cost</b>		
Equipment	200,000	200,000
Furniture and fixtures	<u>10,000</u>	<u>10,000</u>
	210,000	210,000
Less accumulated depreciation and amortization	<u>(22,000)</u>	<u>(22,000)</u>
	<u>188,000</u>	<u>188,000</u>
Right to receive lease payments	<u>-</u>	<u>127,648</u>
Total assets	<u>\$ 225,000</u>	<u>\$ 388,848</u>

**Liabilities and Members' Equity**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Current Liabilities</b>		
Current maturities of long-term debt	\$ 10,000	\$ 10,000
Current maturities of lease liabilities	-	39,455
Accounts payable and accrued expenses	<u>10,000</u>	<u>10,000</u>
Total current liabilities	20,000	59,455
<b>Long-term Debt</b>	125,000	125,000
<b>Lease Liability</b>	-	118,364
<b>Members' Equity</b>	<u>80,000</u>	<u>86,029</u>
Total liabilities and members' equity	<u>\$ 225,000</u>	<u>\$ 388,848</u>

**XYZ Rentals, LLC**  
**Consolidated Income Statement**  
**For the Year Ended December 31, 2010**

	<u>FASB 13</u> <u>(Current)</u>	<u>ASC840</u> <u>(Proposed)</u>
<b>Rental Income</b>		
Lease income	\$ 48,000	\$ 39,455
Service income	3,600	3,600
Interest income on right to receive lease payments	<u>-</u>	<u>14,574</u>
	<u>51,600</u>	<u>57,629</u>
 <b>Rental Expenses</b>		
Salaries	14,000	14,000
Maintenance expense	2,600	2,600
Depreciation and amortization	-	20,000
Other	<u>1,000</u>	<u>1,000</u>
	<u>17,600</u>	<u>37,600</u>
 <b>Net Rental Income</b>	-	20,029
<b>Income from Rental Activity Before Interest and Depreciation and Amortization</b>	34,000	-
 <b>Depreciation and Amortization</b>	22,000	2,000
 <b>Interest Expense</b>	<u>7,000</u>	<u>7,000</u>
 <b>Net Income</b>	<u>\$ 5,000</u>	<u>\$ 11,029</u>

**XYZ Rentals, LLC**  
**Consolidated Statement of Cash Flows**  
**For the Year Ended December 31, 2010**

	<b>FASB 13 (Current)</b>	<b>ASC840 (Proposed)</b>
<b>Operating Activities</b>		
Net income	\$ 5,000	\$ 11,029
Items not requiring (providing) cash		
Depreciation and amortization	22,000	22,000
Changes in		
Accounts receivable	(4,000)	(4,000)
Inventories	(5,000)	(5,000)
Prepaid expenses and other	(3,000)	(3,000)
Cash receipts for leases	-	48,000
Right to receive lease payments	-	(14,574)
Lease liability	-	(39,455)
Accounts payable and accrued expenses	10,000	10,000
Net cash provided by operating activities	25,000	25,000
<b>Investing Activities</b>		
Purchase of property and equipment	(210,000)	(210,000)
Net cash used in investing activities	(210,000)	(210,000)
<b>Financing Activities</b>		
Issuance of long-term debt	135,000	135,000
Net cash used in financing activities	135,000	135,000
<b>Decrease in Cash and Cash Equivalents</b>	(50,000)	(50,000)
<b>Cash and Cash Equivalents, Beginning of Year</b>	75,000	75,000
<b>Cash and Cash Equivalents, End of Year</b>	\$ 25,000	\$ 25,000
<b>Supplemental Cash Flows Information</b>		
Interest paid on long-term debt	\$ -	\$ -
Initial recognition of right to receive lease payments asset and associated liability	\$ -	\$ 197,274

**XYZ Rentals, LLC**  
**Notes to Consolidated Financial Statements**  
**December 31, 2010**

**Note X: Lease Accounting**

***Amounts Recognized in the Financial Statements***

The Company entered into an agreement with a lessee on January 1, 2010 for certain equipment for a five year term, with no renewal options. As part of the lease, the Company has agreed to provide maintenance for the equipment, based on usage, with a minimum of \$3,600 annually. During 2010, total service income related to the maintenance agreement totaled \$3,600.

The performance obligation approach was applied as the Company has the expectation to generate significant returns by re-leasing or selling the underlying equipment.

The right to receive lease payments and lease liability changed during the year as follows:

	<b>Right to Receive Lease Payments</b>	<b>Lease Liability</b>
Beginning balance	\$ -	\$ -
Recognition of present value of lease payments	197,274	(197,274)
Amortization of lease liability	-	39,455
Interest income on right to receive lease payments	14,574	-
Cash payments	(48,000)	-
Ending balance	\$ 163,848	\$ 157,819

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

The rate charged to the lessee for the equipment lease at inception was 8%, which was used to compute the present value of lease payments.

Future minimum lease payments at December 31, 2010, were:

2011		\$ 48,000
2012		48,000
2013		48,000
2014		48,000
		\$ 192,000