Lease Accounting Appendix B – Examples of Proper Lessee Accounting

Contact FAR For schools or units for assistance around lessor accounting.

Example #1 - Operating vs. Finance Lease

On July 1, Campus Services entered into an agreement with an external party to lease a building (an asset with a 35-year useful life) for 20 years. The following details are available:

- Annual lease total payment is $1,150,000 which is comprised of $1,100,000 base cost and $50,000 maintenance costs (paid at the end of each year).
- Lease Commissions of $200,000 to be paid at lease inception.
- The building was newly acquired by the lessor. By reviewing publicly available sale price, Campus Services determines that the building's fair value is $16,000,000.
- The implicit rate in the lease is not readily available. The University's incremental borrowing rate on July 1 is 6% (the rate that the University would have incurred to borrow same amount).

Since the lease term is 3 years or greater and annual rental payments are above $1,000,000, Campus Services assesses for finance lease classification. If annual rental payments were less than $1,000,000, or if the lease carried a term less than 3 years, the lease would be treated as an operating lease.

	Criteria	Answer	Comments
1.	Does ownership of the asset transfer to the University by the end of the lease term?	**No**	There is no provision in the lease agreement stating that the asset will be transferred to the lessee at the end of the lease.
2.	Does lease grant lessee an option to purchase the asset that lessee is reasonably certain to exercise?	**No**	The lease agreement does not contain a purchase option (e.g., that the building can be purchased for $1 at the end of the lease term).
3.	Does the lease term make up a "major part" of the asset's remaining economic life? * * Consider "major part" to be 75% or more of the leased asset's remaining economic life.	**No**	The lease term equals 57% of the economic useful life. (20 years/35 years), which is less than 75%.
4.	Does the sum of the present value of the lease payments make up "substantially all" of the asset's fair value? * * Consider "substantially all" to be 90% or more of the fair value of the leased asset	**No**	Present value of the lease payments calculation: Annual base lease cost $1,100,000 Annual fixed maintenance costs $ 50,000 **Annual Lease Payment** **$1,150,000** The present value of a twenty-year annuity with annual lease expense of $1,150,000 and an incremental borrowing rate of 6% is calculated using the criterion 4 section of the "Lease classification form." This amount is $13,190,409. Therefore, the present value of the lease equals 82% ($13,190,409/$16,000,000) of the fair value of the lease asset, which is less than 90%. Note that the lease commission of $200K is considered an indirect cost and is not included in the lease payment measurement.
5.	Is the leased asset so specialized that is has no alternative use to the lessor at the end of the lease term?	**No**	The leased space will still be of use to the lessor at lease end.

Example # 1 conclusion: This is an operating lease, because it does not meet any of the five capitalization criteria.

Summary of amounts to be used in the journal entries for Example #1 below:
Lease commission payment made by the tub at the beginning of the lease: $200,000
Portion of lease commission to be recognized over the life of the lease term: $200,000/20years = $10,000 per year
Annual lease payments: $1,150,000
Annual maintenance costs included in the lease payment: $50,000

<u>Entries by HRES (lessee)</u>

The tub processes a payment request in B2P to record the prepaid lease commission at the inception of the lease:

Dr - O/C 0540, "Prepaid+Accrued Items"	$200,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$200,000

At the end of the year, the tub makes the following adjusting entry to expense a portion of the prepaid lease bonus (on a straight-line basis):

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	$ 10,000	
Cr - O/C 0540, "Prepaid+Accrued Items"		$ 10,000

The tub processes a payment request in B2P to record the lease payment and maintenance cost:

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	$1,100,000	
Dr - O/C 7120, "Improvements+Alterations to Space, Not Capitalized, GENERAL"	$ 50,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$1,150,000

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.

NOTE: The tub should include in its Commitment and Contingencies annual submission to FAR the above lease detail including any lease commission and incentive amounts. Based on this submission, FAR will make the necessary journal entry to recognize the lease on the tub-level balance sheet in the ROU Asset and Lease liability financial statement line items.

Example #2 - Operating vs. Finance Lease

On January 1, HMS entered into an agreement with an external party to lease scientific equipment (an asset with an 8-year useful life) for a 4-year period. The following details are available:

- A one-year renewal option exists for the lessee and is subject to a termination penalty.
- Annual lease payments total $1,250,000 (paid at the end of each year).
- Included in the annual lease payments are $50,000 of maintenance costs.
- The scientific equipment was newly acquired by the lessor. By obtaining prices from several external vendors, HMS determines that the equipment's fair value is estimated at $6,500,000.
- The implicit rate in the lease is not readily available. The University's incremental borrowing rate on January 1 is 7% (the rate that the University would have incurred to borrow same amount).
- HMS will make payments out of their unrestricted undesignated fund (000001).
- HMS has the right to obtain title to the equipment at the end of the lease term for the bargain price of $1.

Since annual rental payments are above $1,000,000, HMS assesses the lease for finance lease classification. If annual rental payments were less than $1,000,000, the lease would have to be treated as an operating lease.

	Criteria	Answer	Comments
1.	Does ownership of the asset transfer to the lessee by the end of the lease term?	**No**	There is no provision in the lease agreement stating that the asset will be transferred to the lessee at the end of the lease.
2.	Does lease grant lessee an option to purchase the asset that lessee is reasonably certain to exercise?	**Yes**	Yes - HMS can buy the equipment at the end of the lease for a bargain price of $1.
3.	Does the lease term make up a "major part" of the asset's remaining economic life? * * Consider "major part" to be 75% or more of the leased asset's remaining economic life.	**No***	Original term 4 years One-year renewal period** <u>1 year</u> **Total lease term 5 years** **The additional one-year renewal period is included as part of the lease term because it is assumed that HMS will renew the lease due to the termination penalty associated with not renewing for another year. The lease term equals 63% (5 years/8 years) of the economic useful life, which is less than 75%.
4.	Does the sum of the present value of the lease payments make up "substantially all" of the asset's fair value? * * Consider "substantially all" to be 90% or more of the fair value of the leased asset	**No***	Present value of the lease payments calculation: Annual base lease cost $1,200,000 Maintenance costs <u>$ 50,000</u> **Actual lease expense $1,250,000** The present value of a 5-year annuity with annual lease expense of $1,250,000 and an incremental borrowing rate of 7% is calculated using the criterion 4 section of the "Lease classification form." This amount is $5,125,247. Therefore, the present value of the lease is 79% ($5,125,247/$6,500,000) of the fair value of the lease asset, which is less than 90%.
5.	Is the leased asset so specialized that is has no alternative use to the lessor at the end of the lease term?	**No**	The leased equipment will still be of use to the lessor at lease end.

* Note that since the response to criterion 2 is yes, criteria 3, 4, and 5 are not required to be tested, but are shown here for informational purposes.

Example #2 conclusion: The lease is a finance lease, because it meets at least one of the five capitalization criteria (criterion 2 above).

Summary of amounts to be used in the entries below:
Annual lease payments: $1,250,000
Annual maintenance costs included in the lease payment: $50,000
Net present value of annual lease payments: $5,125,247
Liability amortization is calculated using the effective interest method - See schedule 1 on the next page
Leased asset depreciation calculation: $640,656 ($5,125,247 ÷ 8 years)

Entries:

At the inception of the lease, FAR records the following entry to establish the finance lease asset and the related liability:

Dr - O/C 1003, "CO^Equip, Scientific, Nonsponsored"	$5,125,247	
Cr - O/C 2793, "CO^Finance Lease Equipment Liability"		$5,125,247

HMS processes a payment request in B2P to record the lease payment and maintenance cost. Amounts are derived from the liability amortization table included in schedule 1:

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	$1,250,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"		$1,250,000

On a quarterly basis, HMS compiles a manual journal entry to amortize the finance lease liability and charge interest expense, while reversing the charge to rent expense created upon payment. As the lease liability is reduced, equipment equity must be increased to balance the equipment equity equation. Included in HMS's supporting documentation is the funding source they have chosen for the payments, designated as 000001. Once the entry is compiled by HMS, it is sent to FAR to upload/post due to central-only object code usage:

Dr – O/C 2793 "CO^Finance Lease Equipment Liability"	$891,233	
Dr – O/C 7621 "Other External Interest Expense	$358,767	
Cr - O/C 7230, "Rentals+Leases of Space, GENERAL"		$1,250,000
Dr - O/C 9330, "Transfers to/from Funds Invested in Equipment - PIS" Fund 000001	$891,233	
Cr - O/C 9301, "Transfers to/from Unrestricted Undesignated Balances" Fund 724001		$891,233

After this entry is made, the new equipment equity amounts continue to balance as follows:

Equipment asset = $5,125,247
Equipment debt = $4,234,014 ($5,125,247 less $891,233 of lease obligation amortization)
Equipment net assets = $891,233

Schedule 1: Obligation amortization

Date	Lease payment	7% Interest Expense	Obligation amortization	Balance of lease obligation
				$ 5,125,247
Year 1	$ 1,250,000	$ 358,767	$ 891,233	$ 4,234,014
Year 2	$ 1,250,000	$ 296,381	$ 953,619	$ 3,280,395
Year 3	$ 1,250,000	$ 229,628	$ 1,020,372	$ 2,260,023
Year 4	$ 1,250,000	$ 158,202	$ 1,091,798	$ 1,168,224
Year 5	$ 1,250,000	$ 81,776	$ 1,168,224	$ 0

Note: No manual journal entries are required to amortize down the Finance Lease asset. Once the asset is recorded in Oracle Fixed Assets, the asset is automatically amortized on a monthly basis, with the straight-lined expense recorded as depreciation expense over the asset's useful life (since criterion number 2 was met):

Dr - O/C 7571, "Nonsponsored Equipment, Fixtures, Furniture Depreciation"	$640,656	
Cr - O/C 1181, "CO^Equip, Scientific, Nonsponsored, Acc Depr"		$640,656

Example # 3 - Straight-line rent calculation

On July 1, FAS leased a piece of equipment from an outside vendor. The lease agreement states that the equipment will be leased for three years for a total amount of $1,800,000. FAS will make a $375,000 payment at the end of year one, a $600,000 payment at the end of year two, and an $825,000 payment in the last year. The lease is classified as an operating lease. On a straight-line basis, the lease expense is $600,000 per year ($1,800,000/3 years). Since the per-unit annual rent payments are above $500,000, FAS must make adjusting entries to charge rent expense on a straight-line basis.

Year 1

FAS processes a payment request through B2P to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	$375,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$375,000

The following adjusting entry must be made at the end of year 1:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	$225,000	
Cr - O/C 2751, "Misc Deposits+Other Liabilities"		$225,000

By recording this entry, FAS is recording $225,000 of additional rent expense, bringing the total to $600,000 rather than just the $375,000 paid. The net effect to the CINA is the $600,000 straight-line rent expense amount.

Equipment asset – equipment debt = equipment equity (net assets)

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.

<u>Year 2</u>

FAS processes a payment request through B2P to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	$600,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$600,000

The lease payment equals the calculated straight-line basis rent; therefore, no adjustment is necessary at fiscal year-end. The net effect to the CINA is the $600,000 straight-line rent expense amount.

<u>Year 3</u>

FAS processes a payment request through B2P to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	$825,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$825,000

The following adjusting entry must be made at the end of year 3:

Dr - O/C 2751, "Misc Deposits+Other Liabilities"	$225,000	
Cr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"		$225,000

By recording this entry, FAS is ensuring that the recognized rent expense for the period is $600,000 rather than the $825,000 paid. FAS is also offsetting the $225,000 liability established in year 1. The net effect to the CINA is the $600,000 straight-line rent expense amount.

Note: In the example above the lease term and the University's fiscal year-end coincide. This might not always be the case. If these dates differ then the adjustment calculation will be different.

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.