LESMARK

LesMark Capital, LLC

CAPITAL LEASE REQUIREMENTS / MITIGANTS

Operating vs. Finance/Capital Lease

The criteria for classifying leases for financial statement accounting under Generally Accepted Accounting Principals (GAAP) is set forth in Financial Accounting Standards Board's (FASB) Statement No. 13, Accounting for Leases. FASB 13 distinguishes between the following two types of leases for lessees:

Operating Lease: Operating lease accounting is based on the assumption that the lessor is renting out the property. The lessor records rental income as received and depreciates the leased property resulting in lease earnings which are evenly recorded over the life of the lease. The lessee records the periodic rental payments as current period expense and does not book the property as an asset or the borrowing.

Finance/Capital Lease: Finance/Capital lease accounting is based on the assumption that the lessor has in effect sold the property and then has a financial receivable instead of an operating asset being rented out. The lessor records interest on the receivable at a constant rate, similar to a loan. In the early years of a capital lease, there is more income being recognized because the "loan" balance is greatest and the interest portion of the payment is larger. The lessee must treat the capital lease as an acquisition of an asset and the incurrence of an obligation. The property is booked as an asset and a corresponding borrowing equal to the present value of the minimum lease payments. Periodic charges are made for depreciation and interest expense.

Capital Lease Mitigants

The FASB also provides specific criteria for capital lease (on balance sheet) treatment through Statement No. 13 and subsequent pronouncements and interpretations. If any on the four following criteria are met, GAAP will require that the lease must be treated as a capital lease on the balance sheet of the lessee.

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

Solution: Lessee must have right to extend the lease via renewal option or to walk away from the property.

2. The lease contains a bargain purchase option.

Solution: At no time during the term of the lease may the lessee have the right to purchase the property at a bargain purchase option.

3. The non-cancelable lease term is 75% or more of the estimated useful life of the leased asset.

Solution: The appraisal will need to provide for an economic useful life of no less than 25% longer that the lease term.

4. The present value of the minimum (non-cancelable) lease payments equals or exceeds 90% of the fair market value of the leased asset.

Solution: The appraised value must exceed the 90% test. The key to this calculation is determining the lessee's incremental borrowing rate.

Note: It should be noted that the FASB is currently considering extensive changes to the capital lease criteria.