

# Identifying Capital and Operating Leases

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Payments for leased corporate assets must be accounted for in financial statements, to accurately reflect the company's financial obligations. There are two accounting methods, one for each type of lease: "operating" or "capital."

The FASB (Financial Accounting Standards Board) has developed objective criteria to help managers identify the type of lease based on whether the risks and benefits of ownership rest with the owner or the lessee of the asset.

In the case of a capital lease, the present value of an asset and its associated liabilities is treated as a debt, and the interest on this amount recorded on the statement. The asset itself is depreciated over time, while its liabilities are amortized as the lease is paid.

In the case of an operating lease, payments are simply expensed as they are made.

## What You Need to Know

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### What is a minimum lease payment?

A minimum lease payment is rent paid for an asset, plus:

- "executory costs" made to the lessor (like maintenance, insurance or taxes)
- the bargain purchase option (which allows the lessee to buy the asset at a predetermined price)
- guaranteed residual value (a kind of insurance protecting the lessor against an unexpected fall in the value of the asset)
- any penalties for failing to renew or extend the lease.

### What rate of interest should be used to discount minimum lease payments, when deciding whether to classify a lease as operating or capital?

The correct interest rate for discounting minimum lease payments to their present value is whichever is the lower of:

- the lessees' "incremental borrowing rate" (the interest rate that would have been charged had the lessee bought the asset and taken out a loan to pay for it), or

- the lessor's implied interest rate if known (a rate that is not stated, but is implicit in the repayment arrangements),

## What to Do

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### Know the Lease Classification Criteria

Until the FASB established its legislation in the 1970s, leasing assets was a common way for companies to avoid declaring their obligations in financial reporting. They only had to disclose leases in statement footnotes (even long-term arrangements), rather than record them as liabilities. So in effect, leasing assets was a means of financing a company off the balance sheet.

However, many analysts and investors felt that since key financial measures (like debt-to-equity or debt-to-capital ratios) are based on obligations that appear solely on the balance sheet, tighter rules for classifying leases were long overdue.

In response, the FASB issued "Statement no. 13, Accounting for Leases" (1976). This established four questions to be asked when determining whether a lease should be defined as operating or capital:

- Is ownership of the asset transferred to the lessee during the term of lease?
- Can the lessee buy the asset at a nominal price—\$1 for example—when the lease expires (the "bargain purchase option")?
- Will the asset be leased for at least 75% of its economic life?
- Is the present value of the minimum lease payments at least 90% of the value of the asset?

If the answer to **all** these questions is "no," then the agreement should be treated as an operating lease. If the answer to **any** of the questions is "yes," it is regarded as a capital lease.

## Understand the Rules of Financial Reporting

### Capital Leases

In the case of capital leases, assets appear on statements as if they had been purchased—so the rental payments are treated as interest on a loan taken out to pay for them. The asset (and its accompanying liabilities) is capitalized either by recognizing the present value of the minimum lease payments, or the value of the leased assets—whichever is the lower. The leased asset is depreciated in the same way as if they had been purchased by the company, while its associated liabilities decrease as the rent is paid.

## Operating Leases

In the case of operating leases, rent is treated as a straightforward expense which is recognized in financial statements at the time it is incurred. The leased asset itself (and associated liabilities) is not recognized.

## Clarify the Gray Areas

The FASB's criteria for classifying leases gave companies objective accounting-based reasons to help them decide between buying or leasing assets. It also provided a set of rules to identify the terms that constitute a capital lease. However, companies can and do continue to manipulate the way they account for leases—perhaps by altering the provisions of a lease to present it as “operating” when in fact, it should be defined as “capital.” If there is any uncertainty about the status of a lease, the key question to ask is whether the lessee has taken on the risks and benefits of ownership. Tests might include whether the lessee pays for maintenance, insurance, and tax; or has guaranteed a precise residual value on the asset. In the end, if the FASB's criteria have been applied and doubt still remains, the decision may be down to the individual judgment of managers.

## Where to Learn More

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### Web Sites:

U.S. Securities and Exchange Commission: [www.sec.gov](http://www.sec.gov)

Financial Accounting Standards Board: [www.fasb.org](http://www.fasb.org)