The Advisor – Summer 2016

Leasing

A lease is an agreement whereby an owner of an asset conveys the right to use the asset to a third party.

In theory, any tangible asset can be leased yet there are cases where intangible assets (such as patents) are leased as well. This newsletter will focus on tangible assets that can be used to enhance the profitability of your business such as production or manufacturing equipment.

During the lease term, ownership of the leased equipment is retained by the lessor even though you (the lessee) maintain possession of it.

Since lessors maintain ownership but not possession of the leased assets, they must protect themselves from seizure of the leased equipment by lenders who have a general security agreement (or "GSA") on all of the assets of the company. They can do this by registering a first charge security interest in the leased equipment. The leased equipment is therefore excluded from any senior lenders' security package under their GSA's.

As part of the agreement you sign with the lessor, you are charged a rental fee on a regular basis (usually monthly) for the use of the equipment during the term of the lease. How you account for the equipment and the lease payments on your financial statements is a function of the terms and conditions outlined in the lease agreement.

Operating Leases

Let's say you wish to lease a new piece of equipment in order to replace an old one that is slow and expensive to maintain. You are provided a quote from one leasing company with a five year term. At the end of the term, you can either return the equipment or buy it from the lessor at its fair market value.

The above would be classified as an operating lease on your financial statements. An operating lease is an agreement whereby an asset is rented to a business and at the end of the term, the asset is either: (a) purchased by the lessee at the estimated fair market value of the asset (which is greater than a nominal amount); or (b) returned to the lessor.

The monthly rental payments would be classified as equipment rental expense on your company's income statement. There would be no recognition of the leased equipment on your balance sheet since all you are doing is renting the equipment for five years.

Capital Leases

Another leasing company provides you a quote for a similar piece of equipment with the main difference being that at the end of the lease term, you can purchase the equipment from the lessor for $1.

This would be classified as a capital lease which is an agreement whereby all of the risks and rewards incidental to ownership of the equipment are transferred to the lessee. In other words, based on the terms of the lease agreement, it is expected that ownership will transfer to you at the end of the lease.

A sure-fire way to determine if a lease quote you are reviewing is a capital lease is if there is a purchase option at the end of the term so small that you'd be silly not to exercise it and buy the equipment. In essence, you have financed the purchase of the equipment through your monthly lease payments. So why not pay a dollar and keep the equipment?!

This is why a capital lease is also referred to as a Direct Financing Lease or Sales-Type Lease. You are in essence buying the asset and financing it through a leasing company.

Accounting rules state that equipment leased under a capital lease should be classified as an asset on your balance sheet and depreciated just like any other purchased asset would. The future lease payments you make would be classified as a liability on your balance sheet in the same way that a bank loan used to finance an asset purchase would.

Accounting rules also outline a few other conditions that result in a lease being classified as a capital lease on your financial statements even if a bargain purchase option doesn't exist. You should consult with your accountant to discuss these further.

Aries Advisory Group has extensive experience in financing your capital purchase requirements. We will assess all available options (including leasing or financing) and recommend what's best for your particular circumstances. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.