

## Chapter 15 Group Project Solution

**Note:** This project uses the Chapter 15 Appendix.

Alcenon Corporation leases the majority of the assets that it uses in operations. Alcenon prefers operating leases (versus capital leases) in order to keep the lease liability off its balance sheet and maintain a low debt ratio.

Alcenon is negotiating a ten-year lease on an asset with an expected useful life of 15 years. The lease requires Alcenon to make ten annual lease payments of \$20,000 each, due at the end of the period, plus a down payment that is due at the beginning of the lease term. The interest rate in the lease agreement is 10 percent. The leased asset has a market value of \$135,800. The lease agreement specifies no transfer of title to the lessee and includes no bargain purchase option.

Write a report for Alcenon's management to explain how much the down payment must be for Alcenon to be able to account for this lease as an operating lease. Use the following format for your report.

Date:

To: Alcenon Management

From: Student Name

Subject: Required amount of the down payment on a lease in order to account for the lease as an operating lease

### Suggested Answer

DATE: \_\_\_\_\_

TO: Alcenon Management

FROM: Student Team

SUBJECT: Required amount of the down payment on a lease in order to account for the lease as an operating lease

1. The lease does not transfer title to the lessee. The lease does not include a bargain purchase option. Therefore, there is no reasonable assurance that Alcenon will obtain ownership of the leased asset at the end of the lease term.

2. The lease term is only 67% of the asset's useful life, rather than 75% or more. Thus, Alcenon will not obtain almost all of the benefits from the use of the leased asset over the term of the lease.

3. To qualify as a capital lease, the lessor must both recover the original investment and earn a return on that investment. The market value of the leased asset is \$135,800.

The present value of the 10 future lease payments is \$122,900 ( $\$20,000 \times$  Present value of annuity at 10% for 10 periods, which is 6.145 from Exhibit 15A-7). Therefore, the down payment must be less than \$12,900, computed as follows:

Market value of the leased asset, which is the threshold amount for classification as a capital lease	\$135,800
Less: Present value of the 10 future lease payments ( $\$20,000 \times 6.145$ , the present value of an annuity at 10% for 10 periods)	<u>(122,900)</u>
To account for the lease as an operating lease, the down payment must be less than	<u>\$ 12,900</u>