Ralph's Leases

Ralph is contemplating potential transactions of an equipment leasing enterprise. As the firm's controller he is concerned about financial reporting options as well as operating/financing decisions. Suppose the events are as follows.

An equipment leasing firm issues stock in exchange for cash proceeds of $120 at time zero. The firm immediately thereafter engages in the following activities:

a. Issues two-year maturity, $200 face value bonds with 10% annual interest payments. Yield on the bonds is 12%; hence proceeds from the bond issue are $193.24 less $1 in issue costs. The firm's accounting choice is to write-off the issue cost during the year of the issue.

b. Acquires equipment with two-year economic life and zero residual value for cash equal to $300.

c. Leases equipment from a supplier with current fair value equal to $100. The term of the lease as well as the economic life of the equipment is two years. The equipment has zero estimated residual value. Lease payments are $58.39 at the end of each year for two years; the imputed annual interest rate is 11%.

d. All of the equipment (in b and c) is bundled with company-supported service warranties and leased to customers. The fair value of the equipment (including the service warranty) is assessed to be $450. The terms associated with these leases are annual year-end $266.26 payments for two years; the annual yield is 12%.

e. At time zero, the estimated warranty costs on the leased equipment are $20. Warranty claims paid during year 1 equal $5 and paid during year 2 equal $15. The firm's accounting choice is that warranty obligations are capitalized when the leases are signed.

f. Straight-line depreciation is the firm's accounting choice for all depreciable assets. The firm's accounting choice on *recognized* debt is effective interest amortization.

Required:

1. Assume the firm employs capital lease accounting for all leases. Complete pro forma time 1, and 2 Balance Sheets, and Income Statements for periods 1 and 2.
(Use T accounts and a directed graph to complete your analysis.)

2. Assume the firm employs operating lease accounting for all leases. Complete pro forma time 1, and 2 Balance Sheets, and Income Statements for periods 1 and 2.
(Use T accounts and a directed graph to complete your analysis.)

3. Ralph is considering leasing equipment with an economic life of four years to customers. The original cost of the equipment is $150 and the current fair value of the equipment is $250. The equipment is to be leased for three years with annual year-end payments and returned to Ralph at the end of the lease. The estimated residual value at the end of four years is $10. Ralph wishes to earn a rate of return equal to 13% on the lease.
Identify the annual payments on the lease that yield the desired rate of return.
(Hint: Construct a T account lease amortization schedule.)