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Accounting Questions: Purchase Option and Depreciation on Leased Property

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ACCOUNTING QUESTIONS

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PURCHASE OPTION AND DEPRECIATION ON LEASED PROPERTY

Question

Corporation A owns a fully equipped plant not used in its current operations. This plant has been idle for more than a year and was recently leased with a purchase option on a four-year term on the following basis:

1. Lessee is to pay an annual rental in monthly payments of a fixed amount.
2. Lessee is required to pay quarterly $3,750 to the lessor which is to be applied towards its option for the purchase of the plant and such payments are to be applied against the purchase price in the event that it exercises its option. Otherwise, these payments shall be considered as additional rent. The lessee has the privilege of exercising its option at any time during the four-year lease period.

The cost of the plant to Corporation A is $400,000 and its book value is $350,000 at the beginning of the lease period. The price at which the lessee may exercise his option is $400,000. During the first year of the lease the lessee rehabilitated the plant and added a new garage building and new equipment at a total cost to him of $100,000.

Corporation A, the owner of the property, requests its accountant, in view of the foregoing facts, to omit from the financial statement the annual depreciation of $15,000 on the above property for the following reasons:

A. The sales option price is $400,000, while its book value is $350,000.
B. In the event the option is not exercised, the benefit of the additions and improvements to the property will revert to Corporation A.
C. The total depreciation for the four-year period on the plant will amount to $60,000, while the depreciated value of the additions and improvements to the plant will have a value in excess of $60,000.

1. How should Corporation A treat the $15,000 it receives annually on account of the option?

2. Is Corporation A's contention that depreciation should be omitted correct?

3. How should the accountant set forth the above transactions on the financial report of Corporation A?

Answer No. 1

The circumstances set forth must be viewed from the standpoint of Corporation A, which is the lessor corporation, but also from that of the lessee. It is apparent from the expenditure of $100,000 made by the lessee that it classes the contract as a conditional sale, that it intends to exercise its option, and that its quarterly payments of $3,750 are intended to be on account of the purchase price. It appears, therefore, that the lessee has an asset subject to performance under the lease and option agreement. From the standpoint of Corporation A, the lessor, it would, in my opinion, be proper, under that construction of the contract, for it to omit the annual depreciation charge and to credit the amounts of $15,000 received annually against its plant account or to a suspense account. At the time when the option is definitely exercised, it can then take up the profit between the amount received and the remaining cost carried on its books.

The foregoing answers questions one and two. In answer to question three, in my opinion, the accountant for Corporation A should show the asset account at its book value of $350,000 with either the deduction from plant shown as payments received on lease and option agreement, or the suspense credit, if carried that way, shown similarly, and the reference, "see footnote." The footnote should state something to the effect that the plant has been leased under option agreement and the lessor's acts should indicate intent to exercise the option. Upon completion of such formality, the plant item will be replaced by an amount of $400,000 receivable, less the amount already received, from Blank corporation.

I would like to add, that whether a lease constitutes a conditional sale or not depends upon the circumstances and finally upon court interpretation in the event of dispute.

For accounting purposes, I believe the foregoing takes cognizance of circumstances so far as can be foreseen and makes full disclosure or reference thereto. For tax-return purposes, it might be safer to claim the depreciation currently on the chance that the option might not be exercised.

Answer No. 2

Answer to question No. 1—The lessor receives an annual rental in monthly payments which should be treated as income for the current year. It is my opinion that the $15,000 received annually on account of the purchase option should be credited to a deferred-income account and if the option is exercised, this deferred income will then be credited to the proceeds from the sale of the plant, and in the event the option is not exercised within the time specified, the deferred income will become earned income upon such concurrence. Another treatment could be made of this $15,000 payment, namely, that percentage of $15,000 which in any event would represent a profit upon the exercise of the option could be taken into the accounts as current income. The proportion of the annual profit earned would naturally be affected by the answer to question No. 2.

Answer to question No. 2—In my opinion, Corporation A should compute depreciation on the plant during the period that it is under option, as obviously such depreciation has occurred whether it is booked or not.

Answer to question No. 3—The items as recorded on the books can be reflected on the balance-sheet in similar form, namely, the $15,000 annually can be set up as a deferred income on sale of capital assets and the annual depreciation charge appear as a deduction from income, preferably as a non-operating expense.

Answer No. 3

1. In our opinion, the quarterly receipts of $3,750 should be credited to a suspense account, appropriately captioned, and allowed to remain in that account until the option is exercised or the term of the option has expired and it is known that it will not be exercised.
2. In our opinion, the corporation is justified in not accruing depreciation on the leased property. This opinion is based upon the fact that in the event the option is not exercised the additions and improvements to the property will become the property of the lessor, and that in that event also the amounts received on account of the option, aggregating $15,000 a year, will become available as depreciation of the leased property.
3. The question as to how the accountants should set forth the above transactions in the financial statements of the lessor corporation depends to a large extent upon the relative importance of the transaction. If the property in question constitutes a material part of the entire property, it seems that an explanation should be made in the balance-sheet—probably in a footnote—that property carried at a net book value of $350,000 has been leased for a four-year period, the lessee having an option to purchase the property for $400,000, and that the lessee is paying $15,000 a year on account of such purchase price, to be forfeited in case the option is not exercised.