Financial Activities Analysis: Hayes, Inc.

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Two possible reasons why the managers, in this case, might resist quantification and accrual of a loss liability are: A contingent loss is a potential loss that may occur in the future, depending on the outcome of an uncertain event, such as a lawsuit, a claim, or a warranty. According to the accounting standards, a contingent loss should be recorded as an expense and a liability in the financial statements if it is probable that the loss will occur and the amount of the loss can be reasonably estimated. However, managers might resist quantification and accrual of a loss liability for several reasons, such as:

- To avoid a negative impact on the financial performance and position of the company. Recording a contingent loss would reduce the company's net income and equity, affecting the perception of the shareholders, investors, creditors, and other stakeholders. It might also affect the ability of the company to meet its financial obligations, such as debt covenants or dividend payments.
- To avoid admitting fault or liability in the legal dispute. Recording a contingent loss might imply that the company acknowledges its responsibility or wrongdoing in the case, weakening its position or bargaining power in the litigation process. It might also encourage more lawsuits or claims from other parties seeking compensation or damages from the company.
- To exploit the uncertainty and discretion involved in the accounting judgment. Estimating the probability and amount of a contingent loss is often a complex and subjective process involving many assumptions, scenarios, and uncertainties. Managers might use their discretion to manipulate or delay the recognition of a contingent loss or to provide inadequate or misleading disclosures to avoid or minimize the impact of the loss on the financial statements.

One possible circumstance when managers might be willing to accrue a contingent loss that they had earlier resisted accruing is when there is a change in the probability or the estimate of the loss. They want to smooth their earnings over time. For example, suppose new evidence or events indicate that the loss is more likely to occur or the loss amount is higher than expected. In that case, the managers may decide to accrue the loss to reflect the updated information and avoid potential penalties or litigation for misrepresenting the company's financial position of the company.

Another possible circumstance when managers might be willing to accrue a contingent loss that they had earlier resisted accruing is when there is a change in the strategic or competitive environment of the company. For example, suppose the company plans to merge with or acquire another company or issue new shares or debt. In that case, the managers may accrue the loss to improve the transparency and credibility of the company's financial statements and facilitate the negotiation or valuation process with the potential partners or investors.

Prepare accounting entries required by Hayes, Inc. for 2017. This is about capital lease accounting, which records a lease transaction where the lessee is considered to own the leased asset and the lessor is treated as a financier. According to the accounting entries required by Hayes, Inc. for 2017 are as follows:

Figure 1: All the details and amounts of the items for Hayes, Inc. lease equipment from Smithsonian Company.

Items	Amount
Lease rental	$25,000
Interest rate for 5 years	8%
Borrowing rate	8.25%
PV of $1 annuity 8% for 5 years	$3.99
PV of the lease payment ($25,000*3.993)	$99,825

Figure 2: These are the accounting entries required by Hayes, Inc. for 2017.

1.Record journal entries in 2017 as Hayes, Inc. requires:			
Date	**Particulars**	**Debit($)**	**Credit($)**
Jan-1-2017	Leased Equipment A/C ($25000*3.993)	$99,825	
	Lease Liability A/C		$99,825
Dec-31-2017	Lease Liability A/C ($25000-$7986)	$17,014	
	Interest Expense A/C ($99825*0.08)	$7,986	
	Cash A/C		$25,000
Dec-31-2017	Depreciation A/C ($99825/5)	$19,965	
	Accumulated Depreciation A/C		$19,965

Compute and illustrate the effect on the income statement for the year ended December 31, 2017, and the balance sheet as of December 31, 2017.

Figure 3: Table shows the income statement for the year ended 2017 by Hayes, Inc.

Income Statement for the Year Ended December 31, 2017	
Particulars	**Amount ($)**
Revenue	-
Expenses	
Interest Expence	$7,986
Depreciation Expence	$19,965
Gains	-
Losses	-
Net Income before tax	-

Figure 4: Table shows Hayes, Inc.'s balance sheet for the year ending 2017.

Balance sheet for the Year Ended December 31, 2017	
Assets	**Amount ($)**
PPE	
Leased Equipment	$99,825
Less: Accumulated Depreciation	$19,965
Net Leased Equipment	$79,860
Liabilities	
Current	
Interest payable	$7,985
Lease Liability ($99825-$17014)	$82,811

Constructing a table showing payments of interest and principal made every year for the five-year lease term. Based on the information, the lease term is five years, the annual lease rental is $25,000, and the interest rate implicit in the lease is 8%. The present value of the minimum lease payments is $99,825, which is the amount of the leased asset and the lease liability.

Figure 5: The table shows the breakdown of the lease payment for each year.

Year	**Cash**	**PV Factor at interest rate 8% (PF Factor=1/1+r)^n)**	**Present Value (PV year 1=lease payment*PV Factor)**		
2017	$25,000	0.925925926	$23,148.15		
2018	$25,000	0.85733882	$21,433.47		
2019	$25,000	0.793832241	$19,845.81		
2020	$25,000	0.735029853	$18,375.75		
2021	$25,000	0.680583197	$17,014.58		
	8% PV minimum payment		$99,817.75		
Year	**Balance**	**Payment**	**Interest rate 8%** (=Balance*8%)	**Principla** (=Payment-Interest)	**Year End** (=Balance-Principle
2017	$99,818	$25,000	$7,985.44	$17,014.56	$82,803.44
2018	$82,803.44	$25,000	$6,624.28	$18,375.72	$64,427.72
2019	$64,427.72	$25,000	$5,154.22	$19,845.78	$44,581.93
2020	$44,581.93	$25,000	$3,566.55	$21,433.45	$23,148.49
2021	$23,148.49	$25,000	$1,851.88	$23,148.12	-

The lease is a capital lease for the lessee and a direct financing lease for the lessor. The first row shows the cash flow, the present value factor, and the present value of the lease payments for each year. The present value factor calculated by dividing 1 by (1 + 8%) raised to the power of the number of years. The present value of the lease payments is computed by multiplying the cash flow by the present value factor. The total present value of the lease payments is $99,817.75, the fair value of the leased equipment and the lease receivable for the lessor.

The second row shows the balance, the payment, the interest rate, the principal, and the year-end balance of the lease liability for each year. The balance is the lease liability amount at the beginning of each year. The payment is the amount of the lease payment made at the end of each year. The interest rate is 8%, the same as the implicit rate in the lease. The principal is the lease payment amount that reduces the lease liability. It is calculated by subtracting the interest from the payment. The interest is computed by multiplying the balance by the interest rate. The year-end balance is the lease liability amount at the end of each year. It is calculated by subtracting the principal payment from the balance.

The table shows how the lease liability is amortized over the lease term, as the principal payments reduce each year's balance. The lessee records the interest expense and principal payments as financing activities. The lessor records the interest revenue and the principal payments as investing activities.

Construct a table showing expenses charged to the income statement for the five-year lease term if the equipment is purchased. Show a column for (1) amortization, (2) interest, and (3) total expenses.

Figure 6: The table shows the five-year lease term's amortization, interest, and total expenses.

Year	Amortization	Interest	Total Expence
2017	$19,965.00	$7,985.44	$27,950.44
2018	$19,965.00	$6,624.28	$26,589.28
2019	$19,965.00	$5,154.22	$25,119.22
2020	$19,965.00	$3,566.55	$23,531.55
2021	$19,965.00	$1,851.88	$21,816.88

The table shows how much of the total yearly expense goes to amortization and interest. Amortization is the process of spreading the cost of an asset over its useful life. Interest is the cost of borrowing money. The total expense is the same as the lease payment of $25,000 annually.

The table result shows that the amortization is constant at $19,965 annually, while the interest decreases yearly. This means that more of the total expense goes to reducing the lease liability each year, and less goes to paying the interest each year.

The table shows how the lease liability is amortized over the lease term and how the interest expense and the principal payments are recorded in the income statement and the balance sheet.

In one paragraph, discuss the income and cash flow implications from this capital lease.

A capital lease is treated as a purchase of an asset by the lessee, who records the leased asset and the lease liability on its balance sheet. A capital lease has the following implications for the income and cash flow statements of the lessee:

Income statement: A capital lease affects the income statement by increasing the interest expense and the depreciation expense of the lessee. The interest expense is the interest that accrues on the lease liability over time, based on the interest rate implicit in the lease. The depreciation expense is the amount of depreciation allocated to the leased asset over its useful life based on the asset's cost. The interest and depreciation expenses reduce the lessee's net

income and earnings per share. A capital lease also affects the income tax expense of the lessee, as the interest and depreciation expenses are deductible for tax purposes, lowering the taxable income and the tax liability of the lessee.

Cash flow statement: A capital lease affects the cash flow statement by increasing the cash flow from operating activities and decreasing the cash flow from financing activities of the lessee. The cash flow from operating activities is increased by the interest and depreciation expenses added back to the net income, as they are non-cash expenses. The cash flow from financing activities is decreased by the amount of principal payment made to reduce the lease liability, as it is a cash outflow. The net effect of a capital lease on the cash flow statement is zero, as the increase in the cash flow from operating activities is offset by the decrease in the cash flow from financing activities.

Figures 3 and 4 show the income statement and the balance sheet for the lessee for the year ended December 31, 2017. Income Statement:

The lessee will report interest expense on the lease liability and depreciation expense on the leased asset. These expenses will reduce the net income before tax of the lease. The interest expense is calculated by multiplying the lease liability balance by the implicit interest rate in the lease, which is 8%. The interest expense for 2017 is $7,986. The depreciation expense is calculated by dividing the cost of the leased asset by the useful life of the asset, which is five years. The cost of the leased asset is the present value of the lease payments, which is $99,825. The depreciation expense 2017 is $19,965, as shown in Figure 3.

Cash Flow Statement:

The lease payments are classified as a combination of both principal (reduction of lease liability) and interest payments (interest expense); the principal payments are cash outflows from

financing activities, while the interest payments are cash outflows from operating activities. The lease payment does not affect the cash flow from investing activities, as the leased asset is not considered a purchase or sale of an asset.

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