Q-1. Solution: B.

The present value of the lease is \$360,477.62. (n = 5, I/Y= 12%, PMT = \$100,000) 12% of the original PV is \$43,257.31 and represents the interest component of the payment in the first year. The difference between the annual payment and the interest is the amortization of the lease obligation included in cash flow from financing. \$100,000 – 43,257.31 = \$56,742.69. Depreciation is \$360,477.62/5 or \$72,095.52 so the total reduction in pretax income would be interest plus depreciation or \$115,352.83. CFO would be reduced by the amount of the interest only because the depreciation would be added back to determine cash flow from operations.

Q-2. Solution: C.

The cash from operations is lower if the lease is classified as an operating lease because the full lease payment is shown as an operating cash outflow. If it is classified as a financing lease, only the portion of the lease payment relating to interest expense reduces the operating cash flow and the portion of the lease payment that reduces the lease liability is classified as a financing cash flow. Therefore, the lessee’s cash from operations tends to be lower under operating leases.

Q-3. Solution: A.

Sales-type lease treats the lease as a sale of the asset, and revenue is recorded at the time of sale equal to the present value of future lease payments. Under a direct financing lease, only interest income is reported as earned. Under an operating lease, revenue from rent is reported when collected.

Q-4. Solution: B.

An operating lease is not recorded on the balance sheet (debt is lower), and lease payments are entirely categorized as rent (interest expense is lower.) Because the rent expense is an operating outflow but principal repayments are financing cash flows, the operating lease will result in lower cash flow from operating activity.

Q-5. Solution: A.

An asset such as deferred customer acquisition costs indicates a delay in the recognition of expense for current period, which can be serve as an indication of low quality earnings.