

Case 15-11
Deal for a Dozer

Sable Inc. (Sable) is a company based in San Francisco that manufactures and supplies earthmoving and construction equipment. Sable either sells the equipment to customers or leases it under terms specific to a customer's needs. Buildit Inc. (Buildit) is a growing construction company in Los Angeles that specializes in building residential properties.

Buildit recently entered into a contract with Sable to lease a bulldozer, which Buildit will use for a new project involving the construction of several condominiums in the Los Angeles area. The pertinent terms of the lease are as follows:

- The lease term is for 10 years, while the economic life of the bulldozer is estimated to be 15 years. The useful life of the bulldozer is also estimated to be 15 years.
- Annual lease payments of \$16,000 are due at the end of each year. Buildit is also responsible for all maintenance, insurance, and taxes arising from the lease of the bulldozer.
- The residual value of the bulldozer is estimated to be \$24,000 at the end of the lease term. Sable does not have a residual value guarantee.
- The lease does not transfer ownership of the bulldozer to Buildit by the end of the lease term or provide an option for Buildit to purchase the equipment.
- The bulldozer costs Sable \$100,000 to manufacture, and this model is currently listed for sale at \$135,000 should customers wish to purchase it outright.

Sable believes that the lease payments from Buildit will be collected when they are due. In addition, the equipment is fully constructed and no additional costs will be incurred to complete production of the bulldozer before lease commencement.

As a result of a recent economic downturn that has directly affected the construction industry, a number of companies in the industry have modified their sales or lease terms to maintain profitability. Some of Sable's direct competitors have negotiated lower lease payments or reduced their selling prices in an effort to stimulate sales. For example, several bulldozers with the same specifications as the one leased to Buildit have recently sold for an average sales price of \$125,000, as opposed to Sable's current list price of \$135,000.

The rate implicit in the lease is 6.9336 percent assuming the fair value of the bulldozer is \$125,000 at the beginning of the lease term and 5.45 percent assuming the fair value is \$135,000.

Required:

1. How should Sable classify the lease in its accounting records?
2. Provide the journal entries that Sable should record to:
 - a. Initially record the lease.
 - b. Account for the first lease payment made to Sable at the end of year 1.