

Lease

Leases are long-term agreements between a firm and its vendors for the firm to rent some property from the vendor for a specified period of time. The company acquiring the use of the property is called the lessee. The company supplying the property is called the lessor. Leases are very important because of the flexibility with which they can be constructed.

Some leases are truly rental agreements and do not represent a substantial change in ownership of the property in question. These are called operating leases. Other leases represent such a complete transfer of value of the property in question that they are effectively a sale of an asset. These leases are called capital leases.

An investor should study closely any lease a company is obligated to. Some firms can be very creative in how they structure their leases. The lease may technically satisfy the definition of an operating lease, but it may effectively be a capital lease.

Incidentally, structuring a lease so that it is not necessary to record a liability (i.e. having it qualify as an operating lease) is one way a firm can engage in off-balance-sheet financing.