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## Leasing Decision at Magnet Beauty Products, Inc.

### Introduction

In late August 2010, Janette Clark, the owner of Magnet Beauty Products, Inc., was evaluating the different leasing options she had for her stores. Two weeks earlier, she had asked David Cameron, a newly recruited accountant, to analyze the impact that the new accounting standard for leases would have on her business. Clark asked Cameron to analyze how the different leasing proposals she had received from her landlord would affect Magnet's financial statements. Cameron's analysis showed that, as a result of the forthcoming accounting changes the different leasing options would have very different impact on the company's financial statements for years to come. She wondered how she should take these differences into account in making her final leasing decision.

### Magnet Beauty Products Inc.

Magnet Beauty Products Inc. was a fast growing start-up selling premium hair, body and face care product. The company was set up in 2005 with the aim to utilize its extensive scientific resources for the creation of beneficial and safe products. Although Magnet started with a limited number of products being offered, it grew to offer a complete skin and hair care range, make-up, and sun care products, and herbal supplements. As of 2010, Magnet offered close to 100 innovative herbal products, employing 300 people and maintaining production facilities of 140 thousands square feet.

The firm differentiated itself from the competition by selling only products made from highly concentrated natural ingredients (**Exhibit 1**). Demand was particularly strong for products that had high concentration of exotic ingredients such as wild rose oil, a natural source of vitamin C, with significant repairing activity for fine lines and skin color disorders, and aloe, rich in vitamin E, Zinc and antioxidant enzymes, which enhance the immune system of the skin. Face products comprised 45% of total sales. Hair and body products equaled 21% and 19% of total sales respectively. Pharmaceutical and other products represented the rest 15% of the sales.

Magnet started its operations with one retail store in downtown Boston, and expanded to thirty-two stores throughout Massachusetts by mid 2010. All stores were occupied under leasing arrangements. The company had leased all its stores from the same lessor, a large real estate company operating in Massachusetts. This gave Magnet the advantage to negotiate the leasing arrangements collectively for all properties under one contract. Apart from the thirty-two stores,

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Professors Krishna Palepu and George Serafeim prepared this case. The company mentioned in the case is fictional. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Magnet was distributing its products through alliances with high-end hotels located in Boston, New York and Miami, and airlines that used Magnet products for passengers that travelled first class.

For the 2009 fiscal year Magnet reported sales of \$52.4 million experiencing a 12% increase from the previous year. Net income after taxes was \$1.4 million, 10% higher than the previous year. Accounts receivable reached \$30 million mainly because of the increasing importance of business coming from deals with luxury hotels and airlines. However, the company was considerably leveraged. Accounts payable and outstanding debt had reached \$20 and \$52 million respectively. The loans carried a 7% interest rate. Total net cash flow for 2009 was negative \$1 million, and negative \$2 million before financing cash flows.

Clark was happy with the way her business was progressing. Assuming that things continued to go well, she was hoping to nurture her start up for the next few years, and then sell the business to one of the large specialty retailers in her space. To achieve this objective Clark considered it important to maintain customer loyalty, focus on cost efficiencies, and as a result improve the profitability and the cash flow position of Magnet.

## Accounting for leases

Existing U.S. lease accounting standards, under Financial Accounting Standard No. 13 (FAS 13), required lessees to classify their lease contracts as either capital or operating leases. Capital leases were leases that transferred to the lessee substantially all the risks and rewards incidental to ownership of the leased asset. All other leases were operating leases.<sup>1</sup> FAS 13 provided four criteria to test whether a lease contract met the test of “substantial transfer of risks and rewards”:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain lease option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
4. The present value of the minimum lease payments equals or exceeds 90 percent of the fair market value of the property.

Leases classified as capital leases were treated as similar to a purchase of the underlying asset with a loan. Consequently, the lessee recognized in its balance sheet the leased item as an asset and an obligation to pay rentals as a liability. Over the term of the lease, the lessee depreciated the leased item and apportioned lease payments between a finance charge and a reduction of the outstanding liability. The lessee recognized no similar assets or liabilities when the lease was classified as an operating lease. Instead, the lessee recognized the annual lease payments under an operating lease as rental expense.

Recently, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) decided to jointly revise their standards on lease accounting after considerable criticism that the existing accounting model for leases failed to provide useful information to users of financial statements. Critics noted that operating leases give rise to assets and liabilities that users of financial statements would like to see on the balance sheet, so they can have a more complete picture of the financial position of a firm. They also argued that the existence of different accounting models for substantially similar leases impairs comparability across companies.

Finally, there was wide-spread concern that FAS 13 provided opportunities to engage in “accounting arbitrage” by structuring transactions to achieve a specific lease classification.

In mid March of 2009 FASB and IASB published a discussion paper with the preliminary views of the board members on how the accounting model for leases would change.<sup>2</sup> The boards appeared determined to eliminate operating leases and treat all leases as capital leases regardless of the particular lease terms. As a result, a lessee would recognize an asset representing its right to use the leased item for the lease term (“right-of-use asset”), and a liability for its obligation to pay rentals for the lease term. Moreover, the board members seemed to favor an approach that would require the capitalization of leases under renewal options,<sup>a</sup> contingent rental arrangements,<sup>b</sup> and residual value guarantees.<sup>c</sup>

The discussion paper specified that the right-of-use asset should be initially measured as the present value of the lease payments discounted using the lessee’s incremental borrowing rate. The proposal suggested that the asset should be amortized over the shorter of the lease term and the economic life of the leased item. The liability to pay rentals would initially be measured as the present value of the lease payments discounted using the lessee’s incremental borrowing rate. The income statement recognition of expenses associated with leases would also be affected under the proposed accounting rules. Under the current accounting model, payments for operating leases were classified as operating expenses on a straight-line basis. Under the proposed accounting model, interest expense associated with the lease payment liability, and depreciation and amortization expense associated with the leased asset would be recorded as expenses. As the liability on the balance sheet declined over the lease term, so would the interest expense. As a result, since rentals under the operating expenses generally remained the same over the life of a lease, expenses recorded under the proposed rules would be usually higher than the currently recorded rental expenses in the initial periods of a lease. The pattern would change the other way during the later part of the lease period. In late August of 2010 FASB and IASB issued an exposure draft supporting the proposals in the discussion paper.<sup>3</sup> The exposure draft included an exception for lease contracts of 12 or fewer months. These contracts could continue be recognized as operating leases.

## Choosing the new lease contract

Clark was initially considering renewing the lease contract for her stores for five years as a three-year lease with a renewal option for two more years. Such a long-term lease would ensure that Magnet would be able to lock in its current store locations for the foreseeable future. The company

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<sup>a</sup> In the boards’ view, the lease term should reflect the entity’s reasonable expectation of what the term will be. The discussion paper proposed that an entity should account for options to extend or terminate a lease by assuming the longest possible lease term that is more likely than not to occur.

<sup>b</sup> In some leases, the amount of each lease payment is variable rather than fixed. This variability can arise because of features, such as contingent rentals, based on price changes, the lessee’s performance derived from the underlying asset, or the usage of the underlying asset. In the boards’ view, the measurement of the right-of-use asset and right to receive lease payments should reflect all rights received, even if the payment or receipt of those rights is contingent.

<sup>c</sup> The discussion paper proposed that entities should account for residual value guarantees, in which a lessee compensates a lessor if the value of the underlying asset at the end of a lease is less than a specified amount, in the same way as it accounts for contingent rentals. In the boards’ view, a residual value guarantee is equivalent to a contingent payment at the end of the lease term.

was beginning to establish a loyal customer base, and store location was an important aspect of cementing this advantage for years to come. The contract had specified that the renewal option would be automatically exercised subject to sales targets for the next three years for \$60 million per year on average. Clark was confident that these sales targets would be achieved and therefore the effective term of the lease was most probably five years. The mall developer was offering Clark an attractive lease contract for the “three plus two years” lease. Under the proposed terms, the annual rental payment would be fixed at \$10 million for the whole five-year period. Lessors were willing to offer better terms for long-term leases because long-term contracts reduced the risk of owing an unoccupied facility by the lessors. Moreover, under the proposed accounting standard, the three plus two lease would allow the developer to recognize as revenue the entire present value of the five year lease payments when the lease was signed.

To analyze the alternatives to the proposed “three plus two years” lease, Cameron had collected a market analysis of the commercial real estate market. Cameron also evaluated the option of one-year leases that could be potentially rolled over at the end of every year. Under this arrangement, Magnet would make no legal commitment to renew the lease beyond the first year. Of course, this meant that Magnet may have to move its stores some time during the next five years, should the current landlord choose not to offer the space on a one-year basis. Further, if Magnet rented retail space year by year, Cameron’s market analysis showed that the forecasted rent would increase 5% every year for the next five years starting from \$10 million in year 1 and reaching \$12.2 million in year 5.

Based on the borrowing rate on the outstanding debt of Magnet, Cameron determined that the incremental borrowing rate of Magnet was 7%. He forecasted sales to increase by 12% every year for the five-year period, a growth rate that was moderately higher than the expected industry growth. Cost of goods sold and research and development expenses were expected to grow at 12% each year. Administrative and distribution expenses were expected to increase by 9% every year, a slower growth rate that reflected the forecasted cost efficiencies.

Clark received the analysis that Cameron had performed, showing how the proposed accounting rules would impact the income statement, the balance sheet, and the cash flow statement under the “three plus two years” lease (**Exhibits 2 to 4**) and the “five one year” leases (**Exhibits 5 to 7**). Under the five year lease, net income was expected to decrease from \$1.5 million to \$0.8 million for year 1 as a result of the accounting change. Moreover, leverage was expected to increase from 4.6 to 6.8. A shorter lease affected the income statement and the balance sheet less dramatically. Under a one-year lease, net income for year 1 would remain \$1.5 million and leverage would equal 4.6. However, the lease payments would be higher in the future, reducing net cash flow before debt issues.

Cameron also informed Clark that the new leasing accounting model was expected to have a widespread impact on many companies.<sup>4</sup> **Exhibits 8 and 9** show the estimated potential effects of the proposed accounting rules on reported leverage and Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) across various industries and countries.<sup>5</sup> The highest increase in leverage and EBITDA was expected for companies in the retail and transportation industries, and in Netherlands, United Kingdom, Italy and France. **Exhibit 10** shows the effect of capitalizing existing operating lease obligations reported in the footnotes of 20 of the largest U.S. retail companies, transportation companies, banks and utilities on the income statement. For most companies higher expenses would be recognized up to the 7<sup>th</sup> year of the lease and the cumulative increase in lease cost in excess of straight line rent expense varied between \$98 million and \$2.66 billion. As a result of the accounting change, public companies were expected to record about \$1.3 trillion in leases on their balance sheets, according to estimates by the Securities and Exchange Commission. Because many

private companies also follow GAAP accounting, the number could be closer to \$2 trillion, according to experts.<sup>6</sup>

As a small business owner, Clark was very concerned about managing her cash flows, to minimize the need for external financing. However, she also felt that Magnet's reported profits could be important in determining the company's value when she was ready to sell her business. Also, till she decided to sell the company, she wanted to make sure that she could present attractive financial statements to the banks if she needed a loan to finance Magnet's growth.

As Clark pondered over the two leasing options for her store, she wondered how she should balance the various considerations in making her decision.

**Exhibit 1** Ingredients that are used and not used in Magnet’s products

<b>Ingredients not used</b>	<b>Disadvantages of Ingredients not used</b>	<b>Ingredients used</b>	<b>Advantages of Ingredients used</b>
Silicones	Synthetic, non bio-degraded, which clog the pores, burden hair	Combination of dry vegetable oils	Exceptional compatibility, does not clog pores, does not burden hair moisturizing properties
Parabens	Conservatives to which a large percentage of the population is overexposed to	Organic acids, food conservatives	Natural, mild, safe
Oil products (mineral oil)	Synthetics, clog skin pores	Excellent quality natural oils	Exceptional compatibility, does not clog pores, moisturizing properties
Propylene-glycol	Dissolution responsible for allergies	Butylene glycol	High compatibility, friendly to the skin
Ethanolamines	Controllers of pH responsible for allergies, rashes	Amino acid L-arginin	High compatibility, moisturizing properties
Synthetic vitamin E (D- and L-tocopherol)	Only D-tocopherol has proven anti-oxidant action	Natural vitamin E (D-tocopherol)	Has a double anti-oxidant action

Source: Casewriters.

**Exhibit 2** Income statement under the proposed accounting model for the '3 plus 2 year lease'

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	\$52,365,734	\$58,649,622	\$65,687,577	\$73,570,086	\$82,398,496	\$92,286,316
Cost of sales	20,127,331	22,542,611	25,247,724	28,277,451	31,670,745	35,471,234
Gross Profit	32,238,403	36,107,011	40,439,853	45,292,635	50,727,751	56,815,081
R&D Expenses	794,566	889,914	996,704	1,116,308	1,250,265	1,400,297
Distribution Expenses	12,087,965	13,175,882	14,361,711	15,654,265	17,063,149	18,598,833
Administrative Expenses	4,566,843	4,977,859	5,425,866	5,914,194	6,446,472	7,026,654
Rent	8,000,000	-	-	-	-	-
Total operating expenses	25,449,374	19,043,655	20,784,281	22,684,767	24,759,886	27,025,783
EBITDA	6,789,029	17,063,357	19,655,572	22,607,868	25,967,866	29,789,298
Depreciation	1,000,000	1,120,000	1,360,400	1,578,948	1,826,487	2,106,633
Interest on Debt	3,646,977	3,646,977	4,016,828	4,359,743	4,667,540	4,929,314
Interest on Lease	-	2,870,138	2,371,048	1,837,021	1,265,613	654,206
Amortization	-	8,200,395	8,200,395	8,200,395	8,200,395	8,200,395
Net Income before taxes	2,142,052	1,225,847	3,706,901	6,631,761	10,007,831	13,898,751
Taxes	728,298	416,788	1,260,346	2,254,799	3,402,663	4,725,575
Net income	\$1,413,755	\$809,059	\$2,446,554	\$4,376,962	\$6,605,169	\$9,173,175

Source: Casewriters.

**Exhibit 3** Balance sheet under the proposed accounting model for the '3 plus 2 year lease'

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
<b>ASSETS:</b>						
Cash	\$2,402,018	\$2,690,260	\$3,013,091	\$3,374,662	\$3,779,622	\$4,233,176
Accounts Receivable	29,732,911	33,300,860	37,296,964	41,772,599	46,785,311	52,399,548
Inventory	30,512,733	34,174,261	38,275,172	42,868,193	48,012,376	53,773,861
PP&E	20,000,000	22,400,000	25,088,000	28,098,560	31,470,387	35,246,834
Less: Accum. Depreciation	(1,000,000)	(2,120,000)	(3,480,400)	(5,059,348)	(6,885,835)	(8,992,468)
Intangible Assets	6,457,880	7,232,826	8,100,765	9,072,856	10,161,599	11,380,991
Right-of-Use Asset	-	41,001,974	41,001,974	41,001,974	41,001,974	41,001,974
Less: Accum Amort: Right-of-Use Asset	-	(8,200,395)	(16,400,790)	(24,601,185)	(32,801,579)	(41,001,974)
<b>Total Assets</b>	<b>\$88,105,542</b>	<b>\$130,479,787</b>	<b>\$132,894,777</b>	<b>\$136,528,313</b>	<b>\$141,523,856</b>	<b>\$148,041,943</b>
<b>LIABILITIES</b>						
Accounts Payable	\$20,078,964	\$22,488,440	\$25,187,052	\$28,209,499	\$31,594,639	\$35,385,995
Lease Obligation	-	41,001,974	41,001,974	41,001,974	41,001,974	41,001,974
Less: Accum. Principal Lease Obligation	-	(7,129,862)	(14,758,814)	(22,921,793)	(31,656,180)	(41,001,974)
Payments	52,099,665	57,383,262	62,282,037	66,679,143	70,418,765	73,318,115
Debt						
<b>Total Liabilities</b>	<b>72,178,629</b>	<b>113,743,814</b>	<b>113,712,250</b>	<b>112,968,824</b>	<b>111,359,198</b>	<b>108,704,110</b>
<b>EQUITY</b>						
Share capital	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Retained earnings	5,926,913	6,735,972	9,182,527	13,559,489	20,164,657	29,337,833
Shareholders' Equity	15,926,913	16,735,972	19,182,527	23,559,489	30,164,657	39,337,833
<b>Total Liabilities and Equity</b>	<b>\$88,105,542</b>	<b>\$130,479,787</b>	<b>\$132,894,777</b>	<b>\$136,528,313</b>	<b>\$141,523,856</b>	<b>\$148,041,943</b>

Source: Casewriters.



**Exhibit 4** Cash flow statement under the proposed accounting model for the '3 plus 2 year lease'

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>						
Net Income	\$1,413,755	\$809,059	\$2,446,554	\$4,376,962	\$6,605,169	\$9,173,175
Adjustments to Reconcile Net Income to						
Net Cash Provided by Operating Activities:						
Amortization	-	8,200,395	8,200,395	8,200,395	8,200,395	8,200,395
Depreciation	1,000,000	1,120,000	1,360,400	1,578,948	1,826,487	2,106,633
Decrease (Increase) in Accounts Receivable	(1,863,000)	(3,567,949)	(3,996,103)	(4,475,636)	(5,012,712)	(5,614,237)
Decrease (Increase) in Inventory	(1,600,300)	(3,661,528)	(4,100,911)	(4,593,021)	(5,144,183)	(5,761,485)
Increase (Decrease) in Accounts Payable	1,205,800	2,409,476	2,698,613	3,022,446	3,385,140	3,791,357
Net Cash Provided by (Used in) Operating Activities	156,255	5,309,452	6,608,948	8,110,095	9,860,295	11,895,838
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Purchase of tangible assets	(1,800,873)	(2,400,000)	(2,688,000)	(3,010,560)	(3,371,827)	(3,776,446)
Purchase of intangible assets	(270,000)	(774,946)	(867,939)	(972,092)	(1,088,743)	(1,219,392)
Net Cash Provided by (Used in) Investing Activities	(2,070,873)	(3,174,946)	(3,555,939)	(3,982,652)	(4,460,570)	(4,995,838)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Principal Payments Under Lease Obligations	-	(7,129,862)	(7,628,952)	(8,162,979)	(8,734,387)	(9,345,794)
Net Debt Issues (Repayments)	990,036	5,283,597	4,898,775	4,397,106	3,739,622	2,899,350
Net Cash Provided by (Used in) Financing Activities	990,036	(1,846,265)	(2,730,177)	(3,765,872)	(4,994,766)	(6,446,445)
Net Increase in Cash	(\$924,582)	\$288,242	\$322,831	\$361,571	\$404,959	\$453,555
Cash, January 1	\$3,326,600	\$2,402,018	\$2,690,260	\$3,013,091	\$3,374,662	\$3,779,622
Cash, December 31	2,402,018	2,690,260	3,013,091	3,374,662	3,779,622	4,233,176

Source: Casewriters.

**Exhibit 5** Income statement under the proposed accounting model for five 1-year leases

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	\$52,365,734	\$58,649,622	\$65,687,577	\$73,570,086	\$82,398,496	\$92,286,316
Cost of sales	20,127,331	22,542,611	25,247,724	28,277,451	31,670,745	35,471,234
Gross Profit	32,238,403	36,107,011	40,439,853	45,292,635	50,727,751	56,815,081
R&D Expenses	794,566	889,914	996,704	1,116,308	1,250,265	1,400,297
Distribution Expenses	12,087,965	13,175,882	14,361,711	15,654,265	17,063,149	18,598,833
Administrative Expenses	4,566,843	4,977,859	5,425,866	5,914,194	6,446,472	7,026,654
Rent	8,000,000	10,000,000	10,500,000	11,025,000	11,576,250	12,155,063
Total operating expenses	25,449,374	29,043,655	31,284,281	33,709,767	36,336,136	39,180,846
EBITDA	6,789,029	7,063,357	9,155,572	11,582,868	14,391,616	17,634,236
Depreciation	1,000,000	1,120,000	1,360,400	1,578,948	1,826,487	2,106,633
Interest on Debt	3,646,977	3,646,977	4,042,307	4,423,099	4,782,069	5,109,247
Interest on Lease	-	-	-	-	-	-
Amortization	-	-	-	-	-	-
Net income before taxes	2,142,052	2,296,380	3,752,865	5,580,821	7,783,060	10,418,355
Taxes	728,298	780,769	1,275,974	1,897,479	2,646,240	3,542,241
Net income	\$1,413,755	\$1,515,611	\$2,476,891	\$3,683,342	\$5,136,820	\$6,876,114

Source: Casewriters.

**Exhibit 6** Balance sheet under the proposed accounting model for five 1-year leases

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
<b>ASSETS:</b>						
Cash	\$2,402,018	\$2,690,260	\$3,013,091	\$3,374,662	\$3,779,622	\$4,233,176
Accounts Receivable	29,732,911	33,300,860	37,296,964	41,772,599	46,785,311	52,399,548
Inventory	30,512,733	34,174,261	38,275,172	42,868,193	48,012,376	53,773,861
PP&E	20,000,000	22,400,000	25,088,000	28,098,560	31,470,387	35,246,834
Less: Accum. Depreciation	(1,000,000)	(2,120,000)	(3,480,400)	(5,059,348)	(6,885,835)	(8,992,468)
Intangible Assets	6,457,880	7,232,826	8,100,765	9,072,856	10,161,599	11,380,991
Right-of-Use Asset	-	-	-	-	-	-
Less: Accum Amort: Right-of-Use Asset	-	-	-	-	-	-
<b>Total Assets</b>	<b>\$88,105,542</b>	<b>\$97,678,207</b>	<b>\$108,293,592</b>	<b>\$120,127,523</b>	<b>\$133,323,461</b>	<b>\$148,041,943</b>
<b>LIABILITIES</b>						
Accounts Payable	\$20,078,964	\$22,488,440	\$25,187,052	\$28,209,499	\$31,594,639	\$35,385,995
Lease Obligation	-	-	-	-	-	-
Less: Accum. Principal Lease Obligation	-	-	-	-	-	-
Payments	52,099,665	57,747,243	63,187,125	68,315,268	72,989,246	77,040,257
Debt	-	-	-	-	-	-
<b>Total Liabilities</b>	<b>72,178,629</b>	<b>80,235,683</b>	<b>88,374,177</b>	<b>96,524,766</b>	<b>104,583,885</b>	<b>112,426,252</b>
<b>EQUITY</b>						
Share capital	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Retained earnings	5,926,913	7,442,524	9,919,415	13,602,756	18,739,576	25,615,690
Shareholders' Equity	15,926,913	17,442,524	19,919,415	23,602,756	28,739,576	35,615,690
<b>Total Liabilities and Equity</b>	<b>\$88,105,542</b>	<b>\$97,678,207</b>	<b>\$108,293,592</b>	<b>\$120,127,523</b>	<b>\$133,323,461</b>	<b>\$148,041,943</b>

Source: Casewriters.

**Exhibit 7** Cash flow statement under the proposed accounting model for five 1-year leases

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>						
Net Income	\$1,413,755	\$1,515,611	\$2,476,891	\$3,683,342	\$5,136,820	\$6,876,114
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:						
Amortization	-	-	-	-	-	-
Depreciation	1,000,000	1,120,000	1,360,400	1,578,948	1,826,487	2,106,633
Decrease (Increase) in Accounts Receivable	(1,863,000)	(3,567,949)	(3,996,103)	(4,475,636)	(5,012,712)	(5,614,237)
Decrease (Increase) in Inventory	(1,600,300)	(3,661,528)	(4,100,911)	(4,593,021)	(5,144,183)	(5,761,485)
Increase (Decrease) in Accounts Payable	1,205,800	2,409,476	2,698,613	3,022,446	3,385,140	3,791,357
<b>Net Cash Provided by (Used in) Operating Activities</b>	<b>\$156,255</b>	<b>(\$2,184,391)</b>	<b>(\$1,561,111)</b>	<b>(\$783,920)</b>	<b>\$191,551</b>	<b>\$1,398,382</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Purchase of tangible assets	(\$1,800,873)	(\$2,400,000)	(\$2,688,000)	(\$3,010,560)	(\$3,371,827)	(\$3,776,446)
Purchase of intangible assets	(270,000)	(774,946)	(867,939)	(972,092)	(1,088,743)	(1,219,392)
<b>Net Cash Provided by (Used in) Investing Activities</b>	<b>(\$2,070,873)</b>	<b>(\$3,174,946)</b>	<b>(\$3,555,939)</b>	<b>(\$3,982,652)</b>	<b>(\$4,460,570)</b>	<b>(\$4,995,838)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Principal Payments Under Lease Obligations	-	-	-	-	-	-
Net Debt Issues (Repayments)	990,036	5,647,578	5,439,881	5,128,143	4,673,978	4,051,011
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>\$990,036</b>	<b>\$5,647,578</b>	<b>\$5,439,881</b>	<b>\$5,128,143</b>	<b>\$4,673,978</b>	<b>\$4,051,011</b>
<b>Net Increase in Cash</b>	<b>(\$924,582)</b>	<b>\$288,242</b>	<b>\$322,831</b>	<b>\$361,571</b>	<b>\$404,959</b>	<b>\$453,555</b>
Cash, January 1	\$3,326,600	\$2,402,018	\$2,690,260	\$3,013,091	\$3,374,662	\$3,779,622
Cash, December 31	2,402,018	2,690,260	3,013,091	3,374,662	3,779,622	4,233,176

Source: Casewriters.

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**Exhibit 8** Impact of new lease accounting standard on leverage and EBITDA across industries

Industry	Increase in leverage (%)		Increase in EBITDA (%)	
	Mean	Median	Mean	Median
Retail and Trade	64	42	55	34
Transportation and Warehousing	31	9	44	14
Telecom	20	8	16	7
Professional Services	19	12	27	20
Amusement	19	4	13	5
Accommodation	18	6	30	10
Wholesale Trade	17	8	21	11
All companies	13	4	18	7
Manufacturing	9	5	13	7
Construction	8	4	14	6
Oil, Gas and Mining	7	1	10	2
Financial services	6	2	15	5
Utilities	2	0	6	3

Source: "Proposed lease accounting: research of impact on companies", PricewaterhouseCoopers, available at: <http://www.pwc.com/be/en/publications/pdf/Proposed-lease-accounting-PwC-10.pdf>, accessed August 15, 2010.

Leverage is interest bearing debt over shareholder's equity. EBITDA is earnings before interest, taxes and depreciation.

**Exhibit 9** Impact of new lease accounting standard on leverage and EBITDA across countries

Country	Increase in leverage (%)		Increase in EBITDA (%)	
	Mean	Median	Mean	Median
Netherlands	27	12	27	12
United Kingdom	20	9	24	11
Italy	20	4	30	11
France	20	10	31	22
Sweden	17	7	21	12
Germany	16	5	18	10
United States	15	5	15	7
All companies	13	4	18	7
Switzerland	12	4	28	10
Singapore	8	3	20	7
Hong Kong	7	1	18	4
China	5	1	13	2
Japan	2	1	30	14

Source: "Proposed lease accounting: research of impact on companies", PricewaterhouseCoopers, available at: <http://www.pwc.com/be/en/publications/pdf/Proposed-lease-accounting-PwC-10.pdf>, accessed August 15, 2010.

Leverage is interest bearing debt over shareholder's equity. EBITDA is earnings before interest, taxes and depreciation.

**Exhibit 10** Impact of new accounting standard on timing of lease expense for 20 large US firms

Company	Cumulative increase in lease cost in excess of straight line to turn around point	Year of turn around	1st year increase in lease cost vs straight line	% in excess of straight line cash expense in the 1st year
Walgreen's	2,664	10	456	23
CVS	1,500	9	330	19
Wal-Mart	838	8	194	17
Home Depot	581	9	125	16
Target	487	15	50	21
Sears	374	6	118	14
Kroger	323	6	112	14
Best Buy	275	6	127	12
Delta A/L	298	7	110	10
United A/L	303	7	149	11
Cont A/L	777	7	223	16
American A/L	498	7	146	15
US Air	624	7	285	11
FEDEX	632	7	211	12
BNSF	437	7	117	19
Bank America	913	6	305	13
JP Morgan	891	7	269	16
Citigroup	319	4	157	11
Exelon	98	9	21	16
AEP	178	7	55	18

Source: "An analysis of the impact on lessees of the new approach to lease accounting", William Bosco, available at: <http://fasri.net/wp-content/uploads/2010/03/elfa-cfo-mag-article-2.pdf>, accessed August 15, 2010.

Results are in millions of \$.

## Endnotes

<sup>1</sup>"Accounting for lease", Financial Accounting Standards Board's Statement No. 13, 1976.

<sup>2</sup>"Discussion paper: leases, preliminary views", Financial Accounting Standards Board's Statement No. 1680-100, 2009.

<sup>3</sup>"Proposed accounting standards update: Leases", Financial Accounting Standards Board's update No. 1850-100, 2010.

<sup>4</sup>"New accounting rules ruffle the leasing market", Julie Satow, The New York Times, June 22 2010, available at: <http://www.nytimes.com/2010/06/23/realestate/commercial/23fasb.html>

<sup>5</sup>Source: "Proposed lease accounting: research of impact on companies", Price Waterhouse Coopers, available at: <http://www.pwc.com/be/en/publications/pdf/Proposed-lease-accounting-PwC-10.pdf>, and "An analysis of the impact on lessees of the new approach to lease accounting", William Bosco, available at: <http://fasri.net/wp-content/uploads/2010/03/elfa-cfo-mag-article-2.pdf>.

<sup>6</sup>"New accounting rules ruffle the leasing market", Julie Satow, The New York Times, June 22 2010, available at: <http://www.nytimes.com/2010/06/23/realestate/commercial/23fasb.html>