

## Case 08-4

### The Bear Minimum

Big Bear Power is a public utility company that has posted strong financial results for several years. Big Bear has positive cash flow, and it is in compliance with all its debt covenants. Big Bear leases a combustion turbine from Goliath Co for a 10-year non-cancelable term. The lease agreement is signed on December 15, 2004 and Big Bear's right to use the turbine begins on January 1, 2005. Various provisions and other facts from the lease are listed below.

#### Provision 1

Big Bear pays Stipe, Berry, Mills and Buck LLP, its external legal counsel, \$500K in connection with negotiating the lease agreement. Big Bear is also required to pay \$1 million of legal fees incurred by Goliath Co.

#### Provision 2

The stated default provisions in the lease include a provision that requires a penalty payment if Big Bear's bank declares a default under its primary credit arrangement. Big Bear will be in default under the credit arrangement if there is a "material adverse change" in its financial condition. "Material adverse change" is not defined in the loan documents. The Company believes the likelihood of default is remote. The bank has no relationships with Goliath Co. (Note: This is a customary provision in leasing arrangements.)

#### Provision 3

The lease agreement stipulates that Big Bear's annual lease payments shall be \$1 million per year, payable ratably over 12 months at the beginning of each month. For each calendar year of the term of the lease after 2005, Big Bear will pay minimum rent in an amount equal to \$1 million increased (but not decreased) by the same percentage as the increase in the Consumer Price Index (CPI) from January 1 of the prior year until January 1 of each respective year. The most recent annual increase in CPI as of the inception of the lease was 4%.

#### **Required:**

- For each provision presented, evaluate whether the costs or potential costs associated with the provision should be included in "minimum lease payments," as defined in ASC 840 (FASB Statement No. 13, *Accounting for Leases*).