

# Cebu and Woodard Leases - A PBL Unfolding Problem: Problem Handouts



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## Phase 1

It is New Year's Eve, December 31, 2001, and lucky you! Instead of preparing for the night's festivities, you are attending the closing of a lease deal between two of your clients, Woodard Corporation and Cebu Inc. Woodard has leased an item of equipment to Cebu. After the lawyers leave, the Controller of Cebu turns to you and says, "I asked you to attend this meeting because no one on my staff has any knowledge of lease deals. What will be the accounting implications of the lease I just signed?"

### ***Directions:***

This is a Problem-Based Learning exercise. As part of your analysis, you must ascertain what additional information you need. Use the PBL worksheet to make three lists:

1. What do you know?
2. What do you need to know?
3. How will what you know and what you need to know help you solve this problem?

Also, discuss in your groups where you would find the additional information you need.

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## Phase 2

As you examine the lease document, you discover that there is no option for Cebu to purchase the equipment at the end of the lease. It is to be returned to Woodard after Cebu has used it for ten years. The lease is noncancelable. The lease requires Cebu to make ten annual lease payments of \$21,000 beginning on the date of the signing. The annual lease payments include \$1,000 per year that the Woodard will use to pay for maintenance, taxes, and insurance on the equipment. The implicit interest rate, which is stated in the lease, is 10%.

You make some inquiry about the equipment leased by Cebu and find that its useful life is twelve years. It will have no salvage value at the end of that twelve-year period. Cebu uniformly used straight-line depreciation on all of its equipment. You also find that Cebu has an incremental borrowing rate of 12 percent.

### ***Directions:***

With this additional information answer the following questions:

1. How can you use this additional information?
2. Is there anything additional that you need to know?
3. How will what you know and what you need to know help you solve this problem?

Your group should use a PBL worksheet to help organize your thoughts.

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## Phase 3

After you deliver your findings to the Controller at Cebu, an audit partner informs you that you will be working on the Woodard audit. When you get there you are assigned the lease account. You discover that Woodard made the following journal entry when the lease with Cebu was signed:

Cash	\$21,000	
Lease Revenue		\$21,000
<i>to record lease income</i>		

### Directions:

Assess the propriety of this journal entry and prepare a report indicating the correct accounting for this lease by Woodard.

1. What information do you already know that will help you complete this assignment?
2. How will you use this known information?
3. Do you need any other information?
4. How will you use the information you have and any additional information?



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## Phase 4

As you conduct your audit of Woodard you discover some interesting additional facts.

1. Woodard manufactures the equipment that it leased to Cebu. They normally sell this equipment for \$139,040. Your inquiries indicate that this figure is a reasonable assessment of the equipment's fair market value.
2. You discover a job order cost sheet for the equipment that Woodard leased to Cebu. It indicates that the cost to manufacture the leased asset was \$50,000 for materials and \$25,000 for direct labor. Woodard allocates overhead at a predetermined rate of 50% of direct material cost.
3. Woodard received a credit report on Cebu prior to signing the lease. The report indicated that Cebu had an excellent credit rating.
4. You do not discover any important uncertainties surrounding amounts of unreimbursable costs yet to be incurred by Woodard.
5. Based on past experience Woodard believes the equipment will be worth \$10,000 when it is returned by Cebu at the end of the lease.
6. You find a cancelled check that Woodard wrote to Phillips and Frost, Attorneys at Law. The amount of the check was \$1,500 and the check was dated on the same day that the lease was signed. When you inquire about the check, Woodard management explains it was payment for preparation of the lease documents.

### **Directions:**

Assess the usefulness of the additional information that you have attained.

1. Does the information above have any impact on the accounting for this lease by Woodard?
2. How will you use this information?
3. Do you need any additional information?
4. How would you use the additional information?



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## Phase 5

After you deliver your report to the Woodard Controller, she expresses some confusion about it. Essentially, she wants to know how she will recognize revenue in the years to come.

### ***Directions:***

Consider how you will respond to the controller.

1. Do you need any additional information to answer the controller's question?
2. How will you use this additional information?

Prepare a schedule that will help answer specific questions she may ask of you in a meeting to be held with her and the financial group.

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## Phase 6

Project yourself forward to the end of the lease term. Suppose that when the equipment is returned by Cebu, it has been severely damaged. Woodard realizes it is only good for scrap. They can sell it to the junkyard for \$250.

### ***Directions:***

Prepare a journal entry to record this transaction.



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## Phase 7

During the course of your audit, you discover two additional lease documents. The facts surrounding these documents are identical to the lease transaction between Cebu and Woodard except in the following respects:

1. Document Number 1 is another lease between Cebu and Woodard. In this case production problems at Woodard precluded the company from manufacturing the equipment for Cebu. Because Cebu is such an important customer, Woodard purchased the equipment from another manufacturer, Gorman Company, and leased it to Cebu.
2. Document Number 2 is a lease between Woodard and another customer, Short, Inc. Woodard manufactured this equipment for Short.

When you ask the Controller about these leases, she states that she has been impressed with the accounting work you have accomplished with the first lease with Cebu. She says, "Surely we are now finished with this lease business. These leases must be treated exactly the same as the one you just worked on."

### ***Directions:***

Consider the information concerning these two leases.

1. Is the controller correct?
2. What additional information do you need?
3. How will you use this additional information?



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## Phase 8

When you probe further into the records of Woodard, the following information emerges:

1. Woodard and Gorman Company have a reciprocal agreement to sell each other equipment at manufacturer's cost. Woodard paid Gorman Company \$136,722 for the equipment. Woodard's management decided that they did not want inventory from a rival manufacturer on hand in future years. Therefore they decided to offer Cebu the opportunity to purchase the equipment at the end of the lease term for \$4,000. Woodard management reasoned that Cebu was sure to make this purchase since the equipment would be worth considerably more at that time. In all other respects, the second lease to Cebu is identical to the first lease to Cebu.
2. When you examine the lease to Short, Inc., you find that it is identical to the first lease to Cebu as to all terms and conditions. A credit check of Short, Inc. reveals that it is not a creditworthy company. When you make further inquiry, the controller says, "We decided to take a chance on this one. If Short, Inc. pulls out of this, we will have a large loyal customer in the future that will garner us significant revenue streams. If Short, Inc., goes under, we will get the equipment back. It seemed like the risk was worth it. They made their first and second payments on time."

### ***Directions:***

Analyze the additional information you have attained for these leases.

1. Does this information change anything about the accounting for this lease?
2. If so, what journal entries should be made by Woodard for these leases at the signing?
3. What entries should be made when the first lease payment is received?
4. Do you have sufficient information to account for these leases now? If not, what additional information do you require? How will you use this additional information?

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## PBL Worksheet

Group: \_\_\_\_\_

Date: \_\_\_\_\_

What do we know?	What do we need to know?	How will what we know or what we need to know help us solve this problem?



<p>What have we learned?</p>		

Ó Philip Cottell, Miami University, 2001.

