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Honors Thesis

Impact on Financial Statements of New Accounting Model for Leases

Wenqi Ma

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Abstract

On August 17, 2010 the IASB and FASB published an Exposure Draft on leases. A new accounting model for leases which would include both financing lease and operating leases was proposed. According to the World Leasing Yearbook 2010, \$640 billion was involved in leasing activity, of which a significant amount is not reported on the lessees' balance sheets^[1]. The current leases which firms report in the financial statement notes showed that most companies currently have financing leases although many do not capitalize all of these leases. The new accounting model for leases would be a challenge for companies to make judgments based on estimation of contingent rentals, reassessments of estimates of lease payments and "more likely than not" definition of the "lease term". The purpose of this research is to find out the impact on both lessees' and lessors' financial statement after the implementation of the new accounting model for leases.

Introduction

\$1.2 trillion in future cash obligations for lease aren't reported on the balance sheets among public companies. The new lease accounting model would have great impact on both lessees' and lessors' financial statements based on the differences arise. Operating leases would be eliminated and all leases would be recorded as financing leases. Contingent rent amounts would be included, while amortization and interest expense would replace rent expense and companies would need to continually re-assess lease renewals^[2]. The way the new model works would have great impact on companies' books. Analysis of the impact on both lessees' and lessors' financial statements will be discussed following the application of the new lease model for lease accounting.

First of all, the basic elements of the proposed lease model will be discussed. New rules and application of the new accounting model for leases would lead to a better understanding of the exposure draft. Then simple examples regarding how the income statement and balance sheet of both lessee and lessor would look like are illustrated. Last but not least, parts in the financial statements of the Airlines Company (lessee) and Printing Press Machine Company (lessor) are selected to show where lessee and lessor could find how differently their financial statement would turn out.

Discussion about the proposal continues. The purpose of the Exposure Draft is to solicit comments to consider ways to improve financial statements by reporting all leases on the balance sheet. However, concerns raised among companies regarding whether the lessee took ownership of the leased asset, the accuracy of the estimates made by lessor and the overall complexity of the new models cannot be ignored.

Hypothesis Development

- **General area of interest:**

The Exposure Draft proposed by the FASB on August 15, 2010 was “the first stage of their joint project to address this presumed deficiency by developing a new approach to lease accounting, one that would address the criticisms and provide that appropriate assets and liabilities arising from leases be presented in the balance sheet”^[3]. The purpose of this Exposure Draft aims to provide sufficiently faithful representation of relevant information of leasing transactions. As a result the application of the new model would have a great impact on both lessor and lessor’s financial statement. The lessees would have growth in both assets and

liabilities on the balance sheet and the income statement would be affected as well. The lessor would have growth in both assets and liabilities on the balance sheet as well.

- **Factors that lead to significant differences reported on lessees and lessors' financial statements**

There are lots of difference between the traditional lease model and the new model. These new changes lead to the impacts on lessors' and lessees' books. First of all, "the basic concept referred to internationally as the 'right to use model' will require the lessee to recognize an asset representing the right to use the leased item for the lease term with a liability for the rent to be paid"^[2]. Based on the new model, a lessee with a large amount of leases like a company in the airline industry would have to record assets and liabilities on their books according to their lease term. Furthermore, income statement will also be affected because of the recognition of amortization/interest expense each year, instead of rent expense. Companies will record the highest interest expense in the earliest years of the lease and will reduce as the related obligation is deemed "repaid," so forget the "straight-line" concept of old^[2]. The standard method for using the time value of money to appraise long-term projects used in the new model will provide more accurate cash flows. Net present value will be used to calculate the estimated future payments of the lease liability and the present value of the future leases payments plus initial direct costs will be the new lease asset.

More subjective judgments will be used in determining the expected term of the lease to use in the computations as that number may be a moving target. Companies should get prepared to estimate lease term with precise prediction based on both current and historical data, which might be time consuming. Compared with the traditional lessor accounting model, the new

accounting model for lessor will not have many changes. Basically, lessor accounting would “vary only based on whether the lessor retains exposure to risk/loss during or at the end of the lease”^[1].

- **How companies’ financial reports would be affected**

Because of the attempt to converge GAAP with IFRS, more analysis based on judgments is required to be made. For example, in the lessee’s model, the first step is to determine the lease term. The lease term is defined as “the longest possible term that is more likely than not to occur”, which needs to be estimated and predicted based on analysis and historical data. It’s not just about leasing. There are two models for lessor accounting, the performance obligation approach and the de-recognition approach, which would be used depending on whether lessor is exposed to significant risks or benefits associated with the leased asset or not. Financial preparers are, therefore, required to identify if risks or benefits involved in the leasing are significant or not to the lessor.

For lessees, growth in the balance sheet by recognizing both an asset and liability is the most significant change; additionally, the income statement would be affected by expense recognition on leases previously accounted as operating leases which becomes front-end loaded in the new model; ratios like interest coverage would suffer because of high interest expense, while measure as EBIT(earnings before interest and tax) or EBITDA(earnings before interest, tax, depreciation and amortization) would improve of companies with operating leases substantially^[4]. For lessors, income on leases previously accounted for as operating leases would also be front-ended and balance sheet would also grow for lease under the performance obligation approach^[1].

The basic elements of the FASB and IASB's proposed lessee model

A lessee has acquired a right to use the underlying asset, and it pays for that right with the lease payments. A lessee would record: an asset for its right to use the underlying asset (the right-of-use asset), and a liability to pay rentals (liability for lease payments). The right-of-use asset would originally be recorded at the present value of the lease payments. It would then be amortized over the shorter of its lease term or its useful life of the lease and tested for impairment. The initial lease liability is based on estimates of the lease term, contingent rentals, term option penalties and residual value guarantees. The lessee's incremental borrowing rate or the rate which lessor charges the lessee if it can be readily determined would be used to discount future payments to present value would be used.

The estimates made to determine the initial leases would be reassessed at each reporting date. Changes to the estimated lease term would adjust the related asset and liability; changes due to contingent rentals and expected payments under term option penalties and residual value guarantees would be reflected in profit or loss if they relate to past or current periods and to the right-of-use asset if they relate to the future periods.

Lessee accounting example

Suppose there is a non-cancellable lease for 10 years, with two 5-year renewal options. For lessee accounting, the right-of-use method is used. The first step is to determine the lease term. The lease term is defined as "the longest possible term that is more likely than not to occur". Here are the probabilities to each of the potential lease term ^[1]:

Probability (%)	Lease Term (Year)
40	10
30	15
30	20

Therefore, the longest possible lease term more likely than not to occur is 15 years, because the probability of a 20-year lease term is 30%, the probability of a 15-year lease term is 60% and the probability that the lease term will be 10 years is 100%. When determine the lease term, explicit and implicit renewal options or early termination options included in the contract should be taken into consideration. In assessing the probability of each possible lease term, the contractual factor such as the level of lease payments and contingent payments, non-contractual factors such as the existence of significant leasehold improvements, costs of lost production, relocation costs, and tax consequences, business factors such as whether the underlying asset is crucial to the lessee’s operations or is specialized in nature and past experience or future intentions of the entity. Lease term under the proposed model would be longer, or at least longer than it under the current lease accounting, because current practice requires renewal options to be included in the accounting lease term if they are “reasonably certain” which means a high threshold of being exercised.

The second step is to determine the lease payments. According to the exposure draft, an expected outcome approach described as “the present value of the probability-weighted average of the cash flows for reasonable number of outcomes” would be used. Since the current accounting model that generally excludes contingent rentals from minimum lease payments, a significant change would occur from the current lease accounting model due to the inclusion of contingent rentals. Scenarios and probabilities also need to be developed to estimate the rental payment and discount rate. Two approaches are provided by the ED to measure the right-of-use

asset. One is measured at amortized cost which would amortize the right-of-use asset over the lease term or useful life. The other is measured at fair value in accordance with the revaluation model. Compared to the current model, the new model would result in a higher EBITDA (Earnings before interest, Taxes, Depreciation and Amortization), because amortization and interest expense would replace rent expense is not recorded.

To illustrate how the new model works and find the impacts on lessees' cash flow, balance sheet and income statement, here is a simple example from EMEA ViewPoint ^[6]:

Suppose a lessee enters into a 5 year lease for an office property with a net internal area of 100,000 sq ft. The initial rent is \$20 per sq ft, \$2, 000,000 per annum payable quarterly. The rent increases at a fixed rate of 2% per annum. The lessee has an option to extend the lease for a 5 more years; if the option is exercised the rent continues to increase at 2% per annum and is not re-based to market rent. According to the above steps, the lease term should be determined at first. Although the lease term is for a period of 5 years, the option to extend the lease should be taken into consideration. Based on the analysis of probability, the lessee is more likely than not to renew. For instance, the probability of renewing is greater than 50%, and therefore, the lease term is 10 years. After that, the rent payable should be estimated. A number of scenarios and probabilities need to be taken into consideration. However, since there is 100% probability that can be assigned as the initial rent, only one scenario needs to be considered. To discount the cash flow, the discount rate should also be determined.

In this example, the lessee's incremental borrowing rate is used, because the residual value of the property to the lessor cannot be determined, and therefore the rate the lessor charges the lessee is unknown. The following income statement and balance sheet give a comparison

between the current and proposed accounting model for leases about how the company will report in the subsequent ten years.

Compared to the current accounting model, no entries are made in the balance sheet under the “off-balance sheet” accounting treatment. However, the new accounting model shows significant amount in both assets and liability.

Balance Sheet - £'m											
y/e	Initial	1	2	3	4	5	6	7	8	9	10
Right-of-use Asset IAS 17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Lease Obligation IAS 17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Right-of-use Asset ED*	15.48	13.93	12.38	10.84	9.29	7.74	6.19	4.64	3.10	1.55	0.00
Lease Obligation ED	(15.48)	(14.54)	(13.50)	(12.32)	(11.03)	(9.60)	(8.02)	(6.29)	(4.40)	(2.29)	0.00
Net Difference in Equity	0.00	(0.61)	(1.12)	(1.48)	(1.74)	(1.86)	(1.83)	(1.65)	(1.30)	(0.74)	0.00

*depreciated cost basis

In the income statement, under the new model the combination of the amortization and interest expense generate a significantly higher total charge in the early years of the lease but with the situation reversing in the later years compared to the current accounting model for leases.

Income Statement £'m											
yr	1	2	3	4	5	6	7	8	9	10	
Rent Expenditure IAS 17	*2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19	2.19	
Amortisation of Right-of-use Asset ED**	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	
Interest Expense ED	1.06	0.99	0.91	0.83	0.74	0.63	0.52	0.39	0.25	0.10	
Total Expenditure ED	2.61	2.54	2.46	2.38	2.28	2.18	2.06	1.94	1.80	1.65	
Difference	(0.42)	(0.35)	(0.27)	(0.19)	(0.09)	0.01	0.13	0.25	0.39	0.54	

*as rent increases are not contingent straight line basis adopted **depreciated cost basis

The Impact of New Lease Model on Airlines' Financial Reports

Most modeling work undertaken by Deloitte so far on the new changes suggests that companies in the airlines industry will generally report lower profits and have lower net assets as a result of the new rules. Since new rules require lessee to bring leases on to balance sheets, while old lease accounting rules allowed companies to keep lease liabilities off their balance sheets. “Southwest Airlines, for example at December 31, 2008 operated 92 leased aircraft, of which 82 were operating leases, or approximately 15 percent of their fleet. Those operating leases are likely to end up being affected by the new rules, adding additional assets and liabilities to balance sheets. Southwest’s leased aircraft are generally older models. Delta Airlines has about 25 percent of its fleet under operating leases, with total payments of over \$12 billion remaining on the leases” [7].

Under the proposed lease accounting model, the PV of the lease rents will be recorded as an asset and liability. Amortization and interest expense would replace rent expense. Higher interest expense in earlier years of the lease would occur and the longer the term of the lease, the more expenses are frontloaded. For example, supposing Delta has a 17-year aircraft lease, the PV of the rents will be capitalized at 85%-89% of cost assuming a 7% discount rate. Based on calculation, for a 17-year \$100 million aircraft lease, the first year expense is \$2.4 million or 26% higher than straight line. The cumulative difference will reach a high point in year nine of 138% great than straight line [8].

<u>P&L Pattern</u>	<u>YR 1</u>	<u>YR 2</u>	<u>YR 3</u>	<u>YR 4</u>	<u>cum thru YR 9</u>	<u>Total 17 YRS</u>
Current GAAP	9.2	9.2	9.2	9.2	82.8	156.5
Proposed GAAP	11.6	11.4	11.2	10.9	95.5	156.5
Difference	(2.4)	(2.2)	(2.0)	(1.7)	(12.7)	0.0
Difference	-26%	-24%	21%	-19%	-	0%
Cum % Diff	-26%	-50%	-72%	-90%	-138%	0%

According to Delta Airlines' 2010 10K report, it owns 591 aircraft, 113 capital lease and 111 operating lease. Under Note 6, Delta leases aircraft, airport terminals, maintenance facilities, ticket offices and other property and equipment. Delta records amount due under capital leases as liabilities (\$2.1 billion for current maturities of long-term debt and capital leases and \$13.2 billion for long-term debt and capital leases in 2010) and assets acquired under capital leases as property and equipment (\$20.3 billion in 2010, \$20.4 billion in 2009) on its Consolidated Balance Sheet. Delta's operating leases which contain payments for construction obligations remain off-balance sheet:

Operating Leases

Years Ending December 31, (in millions)	Delta Lease Payments ⁽¹⁾	Contract Carrier Aircraft Lease Payments ⁽²⁾	Total
2011	\$ 899	\$ 521	\$ 1,420
2012	840	511	1,351
2013	816	504	1,320
2014	770	493	1,263
2015	688	481	1,169
Thereafter	7,096	1,327	8,423
Total minimum lease payments	\$11,109	\$3,837	\$14,946

Under the new lessee accounting model, all the operating leases would be accounted for as rights and obligations, i.e., as assets and liabilities. The lease term would include both non-cancellable periods and optional renewal periods. For Delta, many of its leases include rental escalation clauses and/or renewal options which must be taken into consideration. Also the listed minimum lease payments should include estimating renewals, contingent rents, purchase options and residual guarantees and record the PV as an asset and a liability. Delta also needs to re-assess lease terms and contingent rents continually.

Lessor accounting model

There are two proposed models for lessor accounting: (1) the performance obligation approach and (2) the de-recognition approach. Lessors would record their investment property at

cost depending on the terms of the lease and their effect on the lessor according to the exposure draft. The model to apply for a particular lease contract would be based on whether the lessor retains significant risks and benefits associated with the underlying asset ^[10].

Performance Obligation Approach

The performance obligation approach would be applied by the lessor when the lessor retains significant risks or benefits of the underlying asset. This approach recognizes a right to receive lease payments and a corresponding lease liability of the same amount on the balance sheet. It is unlikely for the lessor to recognize a gain on commencement of the lease under this approach. Also this approach provides essentially symmetrical accounting to the right-of-use approach of lessors.

Given a simple example, supposing there is a three years term of lease with the present value of lease payments equaling \$15,000 based on lessees' incremental borrowing rate. On lessees' balance sheet, a 'right-of-use asset' of \$15,000 and a corresponding 'lease liability' would be recognized and the amortization of right-of-use asset would equal to \$5,000 per year for three years. Symmetrically, a 'right to receive lease payments' of \$15,000 would be recognized by the lessor and the lessor would record the \$15,000 amount as lease liability on the balance sheet ^[11]. In this example, total net effect of this accounting may not be substantially different from existing accounting by lessors for operating leases.

Lessor would continue to recognize the leased asset and related depreciation expense. It would amortize its lease liability and revenue over the lease term. Lease payments received would be allocated between interest income and a reduction of the lease receivable using the effective interest method ^[11].

De-recognition Approach

The de-recognition approach would be used when lessor is not exposed to significant risks or benefits associated with the leased asset. The lessor sells a portion of the leased asset and recognizes a net profit (loss) at lease commencement that is equal to the difference between the present value of the lease payments and the carrying amount of the portion of the leased asset that is derecognized. Under the proposed model, a lessor would record two assets- 1. A financial asset for the lease receivable 2. Non-financial asset for the residual asset. Under the current approach, the lessor records one financial asset- the net investment in the lease (lease receivable) which consists of the present value of the lease payments and the unguaranteed residual value of the leased asset.

Given a simple example, supposing the leased asset has a carrying amount of \$12,000 with 3 years lease term and annual lease payment of \$ 6,000 ^[1]. The present value of the lease payments is \$15000 and leased asset has a fair value of \$16,500. Therefore, the amount of the leased asset to be derecognized and the initial carrying amount of the residual asset is \$10,900 ($\$ 12,000 \times \$ 15,000 / \$ 16,500$). The remaining \$1,100 (difference between carrying amount of \$ 12,000 and \$ 10,900) would be allocated to the residual asset. The balance sheet analysis is that at lease commencement, the lessor would recognize 'lease receivable' asset of \$ 15,000 and 'revenue'. The leased asset would be removed from its books and recognized 'cost of sales' of \$ 10,900. The difference between revenue and lease receivable would be profit (\$ 4,100) .

Lessor Accounting Example

Before using a more complicated example for lessor accounting models, here is the illustration about how the balance sheet and income statement would be affected based on the application of the two models ^[5] .

Is there a transfer of significant risks or benefits of the underlying asset?			
yes		no	
DERECOGNITION		PERFORMANCE OBLIGATION	
Balance sheet		Balance sheet	
Residual asset	X	Underlying asset	X
Right to receive lease payments	X	Right to receive lease payments	X
		Lease liability	(X)
		Net lease asset/(liability)	<u>X</u>
Income statement		Income statement	
Revenue	X	Lease income	X
Cost of sales (gross or net based on business model)	(X)	Depreciation expense	(X)
Interest income	X	Interest income	X

The following example shows the accounting entries under (1) the performance obligation approach, (2) the de-recognition approach, and (3) current operating lease guidance^[10].

Suppose an equipment manufacturer offers a lease option to their customers. The lease term is non-cancellable for five years with no renewal options or residual value guarantees. The annual rental payment is \$7,800. The equipment's normal price is \$35,000, and its cost is \$25,000. The estimated value at the end of the lease term is \$5,667. The discount rate the lessor is charging the lessee is 8 percent.

Here is an illustration of the accounting entries under (1) the de-recognition approach, (2) the performance obligation approach, and (3) current operating lease guidance:

	Derecognition	Performance obligation	Existing operating lease accounting
Journal entry at date of commencement of the lease:			
Lease receivable	31,143 ¹	31,143	
Cost of sales	22,245 ²		
Underlying asset	(22,245)		
Revenue	(31,143)		
Lease liability		(31,143)	
Effect on Account Balances (Debit/Credit)			
<i>Year 1</i>			
Cash	7,800	7,800	7,800
Lease liability		6,229 ³	
Depreciation expense		3,867 ⁴	3,867
Accumulated depreciation		(3,867)	(3,867)
Interest revenue	(2,491) ⁵	(2,491)	
Lease receivable	(5,309)	(5,309)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
<i>Year 2</i>			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated depreciation		(3,867)	(3,867)
Interest revenue	(2,067)	(2,067)	
Lease receivable	(5,733)	(5,733)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
<i>Year 3</i>			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated depreciation		(3,867)	(3,867)
Interest revenue	(1,608)	(1,608)	
Lease receivable	(6,192)	(6,192)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
<i>Year 4</i>			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated depreciation		(3,867)	(3,867)
Interest revenue	(1,113)	(1,113)	
Lease receivable	(6,687)	(6,687)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
<i>Year 5</i>			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated depreciation		(3,867)	(3,867)
Interest revenue	(578)	(578)	
Lease receivable	(7,222)	(7,222)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)

Calculations:

1. Lease receivable is the PV of annual lease payments (\$7, 800) discounted at 8 percent.
The factor can be found on the table of PV of an ordinary annuity of 1 which is 3.9927.
($\$ 31, 143 = \$ 7, 800 \times 3.9927$)
2. Cost of sales is equal to the asset derecognized, which is an allocation of the carrying value measured as the fair value of receivables/normal sales price x cost) ($\$31, 143 / \$35, 000 \times \$25, 000$).
3. The lease liability is amortized on a straight-line basis over 5 years ($\$31, 143 / 5 = \$6, 229$).
4. The underlying asset is depreciated so that at the end of five years the value is consistent with the residual value at the end of the lease term. Note that this amount will not necessarily equal the residual asset calculated under the de-recognition approach.
($(\$25,000 - \$5, 667) / 5 = \$ 3, 867$)
5. The interest income is calculated using the effective interest method based on 8 percent.

The Impact of New Lease Model on Printing Press Machine Companies' Financial Reports

Most companies choose to lease printing machinery instead of buying them. Companies that lease those machines make significant amounts of payment, and in return, lessors provide warranty and maintenance. Lessors of printing press machine bear both significant risks and benefits of their leased assets. Therefore, the de-recognition approach should be used. Here is a more detail example adapted from "lessor example- de-recognition approach" ^[11].

Suppose that ABC Corporation has entered into an agreement to lease a printing press machine to General Company, LLC under 5 years non-cancellable, no renewal options or residual value guarantees lease term with 8% incremental borrowing rate of ABC Corporation. The expected life of equipment is 5 years. Lease date is December 1, 2009 and commencement

date is January 1, 2010. There will be 60 monthly payments of \$5,000 beginning on January 1, 2010. Reassessment will be made throughout the period, no reassessment of contingent rentals, residual value guarantees or impairment occur. Carrying Amount of the equipment at date of inception is \$275,000 and the fair value of the equipment is \$325,000.

Here is the comparison of financial statement impact for life of the lease. Based on the calculations, lease income will start as the highest but reduce gradually from year to year; there will be some amount as receive asset under property and equipment on lessor's balance sheet; de-recognized underlying asset will be recorded as lease expense in the income statement.

Year	Lease Revenue vs. Interest Income and Lease Income		Straight Line Rent Receivable vs. Right to Receive Asset		Derecognized Underlying Asset / Lease Expense Recorded at Inception (Not Recorded Under Current Accounting)	
	FASB 13 (Current)	ASC840 (Proposed)	FASB 13 (Current)	ASC840 (Proposed)	FASB 13 (Current)	ASC840 (Proposed)
2010	\$60,000	\$18,217	None	\$204,809	None	\$(208,654)
2011	\$60,000	\$14,749	None	\$159,559	None	None
2012	\$60,000	\$10,994	None	\$110,553	None	None
2013	\$60,000	\$6,926	None	\$57,479	None	None
2014	\$60,000	\$2,521	None	None	None	None
Totals	\$300,000	\$53,407				
Average Balance			None	\$35,493	None	N/A

Here is the consolidated balance sheet with certain changes between the current accounting model and the proposed accounting model.

Property and Equipment, At Cost

Furniture, fixtures and equipment	1,000,000	725,000
Furniture, fixtures and equipment – residual assets		66,346
Right to receive assets		204,810
	1,000,000	996,156
Less accumulated depreciation and amortization	(100,000)	(100,000)
	900,000	896,156
Total assets	\$ 10,200,000	\$ 10,196,156

Retained earnings	<u>5,150,000</u>	<u>5,146,156</u>
Total stockholders' equity	<u>5,250,000</u>	<u>5,246,156</u>
Total liabilities and stockholders' equity	<u>\$ 10,200,000</u>	<u>\$ 10,196,156</u>

The consolidated cash flow statement will recognize cash payments received for leases as \$60,000 but deduct \$ 56,154 as right to receive lease assets.

	FASB 13 (Current)	ASC840 (Proposed)
Operating Activities		
Net income	\$ 2,560,000	\$ 2,556,154
Items not requiring (providing) cash		
Depreciation	50,000	50,000
Cash payments received for leases		60,000
Changes in		
Accounts receivable	(850,000)	(850,000)
Inventories	(500,000)	(500,000)
Accounts payable and accrued expenses	(350,000)	(350,000)
Right to receive lease assets		(56,154)
Net cash provided by operating activities	<u>910,000</u>	<u>910,000</u>

Finally, lease expenses for \$ 208,654 will be recorded on the consolidated income statement and under operating income; \$ 18,216 will be recorded as interest income from right to receive assets.

Operating Expenses		
Salaries	4,000,000	4,000,000
Lease expense	208,654	208,654
Depreciation and amortization	50,000	50,000
Other	100,000	100,000
	<u>4,150,000</u>	<u>4,358,654</u>
Operating Income		
Lease income	60,000	246,592
Interest income	50,000	50,000
Interest income from right to receive assets		18,216
	110,000	314,808
Other Expense		
Interest expense	250,000	250,000
Other	150,000	150,000
	<u>400,000</u>	<u>400,000</u>
Net Income	<u>\$ 2,560,000</u>	<u>\$ 2,556,154</u>

Results

Under the simple example used in lessee accounting, the first step is to determine the lease term. Three different probabilities and years are given and the longest possible lease term more likely than not to occur can be chosen. Under the current lease accounting standards, the lease would only include non-cancellable periods in the lease term, except where there is compelling economic reason to exercise an option. Apparently, the current standards requires little analysis compared to the proposed rules which requires estimation of periods that are “more likely than not” to be exercised. In order to determine these periods, lessees may use historical data such as early termination options included in the contract. The assessment of the probability of each possible lease term involves many factors including both contractual factors and non-contractual factors. The second step is to determine the lease payments which should include estimated future “contingent” rent amounts while under current lease accounting standards, contingent rents are generally excluded.

Two approaches would be used by lessors depending on the whether the lessor retains significant risks and benefits associated with the underlying asset. Based on the simple examples given, lease income would start as the highest but reduce gradually from year to year; there would be some amount as receive asset under property and equipment on lessor’s balance sheet; de-recognized underlying asset would be recorded as lease expense in the income statement.

Discussion

The Exposure Draft aims to improve financial reporting by bringing all leases “on balance sheet”. Lessees would use a ‘right-of-use’ model for lease accounting. A right-of-use asset representing lessee’s right to use the underlying asset and a liability representing its obligation to pay lease rentals over the leases term would be recognized in its financial statement.

Lessees would estimate the lease term, contingent rentals, term option penalties and residual values guarantees.

Concerns raised regarding to the recognition of a right-of-use asset which might not “provide users of financial statements with a complete and understandable picture of the assets held by the lessee”^[12] and might not be appropriate to use, since the lessee does not take ownership. According to the comments on the exposure draft, the proposed rules distort the economic effect, because the estimated payments from renewals and contingent rents do not meet the definition of liabilities. Therefore, they should not be capitalized. Suggested changes include “amortize the right of use asset at the same rate as the debt amortization. Accrue rent payable at the average of cash paid for rent. Link the lease costs on the profit and loss statement. Label the cost as rent expense, keep the current GAAP definition of the lease term and minimum lease payments and supplement with new principles that deal would contingent rents that are disguised minimum lease payments” etc^[13].

Concerns raised regarding to lessor accounting model includes that the overall benefits of the resulting information may not cover the costs of obtaining it, since lessors are required to make estimations and the costs to convert and report under the proposed rules would outweigh the benefits^[14]. Too much complexity would be related to the estimates of contingent rental lease payments and lease terms. For example, next year’s restaurant sales are hard to predict; estimates for the full 10-or-20-year term of a lease are even more difficult to predict and subject to a wide range of potential estimates.

Conclusion

The financial statements of “a diverse range of industries including retail, financial services, real estate, transportation, power and utilities, tourism and hospitality”^[15] which are

either lessees or lessors would be affected based on the new accounting model for leases. Some concerns raised are specific in certain industries but many concerns expressed were shared by different industries^[15]. As discussed above, the lease term defined as “the longest possible term that is more likely than not to occur” cast doubts. Estimates of lease payments would be costly and create significant volatility in profit or loss. Although concerns are raised, the Exposure Draft would provide financial statement users with more information. Again, the right-of-use model for lessees, the performance obligation approach and de-recognition approach for lessor would be a challenge for companies to make judgments based on estimation of contingent rentals, reassessments of estimates of lease payments and “more likely than not” definition of the “lease term”.