

Accounting for Leases under the Forthcoming Exposure Draft

Will Businesses Welcome the Guidance?

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The old accounting rules for leasing will soon be resigned to history. Gone will be the “bright line” tests of the rules-based accounting standard that called for meeting one or more of four criteria to distinguish whether a leased asset should or should not appear on the balance sheet. The new accounting rules will come a long way in improving one of U.S. GAAP’s most often cited criticisms—that it includes too many arbitrary “bright lines” in the guidance. The old rules will be replaced by a model where all long-term leases appear on the balance sheet, while businesses can elect whether short-term leases will appear on the balance sheet.

The new rules will improve the transparency of financial statements by eliminating “off-balance sheet” accounting for leases and the unfaithful representation of the rights and obligations of lessees arising from long-term operating leases. Critics, however, might wonder if the old bright lines will simply be replaced by fuzzy and illogical ones.

New Lease Accounting

Under the new lease accounting proposed by the joint IASB/FASB committee, a lease will exist when a contract—

- requires the use of a *specified asset* and
- conveys the right to *control the asset* for a period of time.

Control will be based on the ability to direct and obtain benefit from the asset’s use. A lessee *buys* the right to control the leased asset; in other words, the lessee buys an intangible asset designated as a “right-of-use” (ROU) asset. (Even though the



ROU asset appears to be intangible, the boards have not called it such, because that would create regulatory capital issues for banks.) The lessee will not own the underlying asset, but will be entitled to its use. (Guidance will not be provided for distinguishing a lease of an underlying asset from a purchase or a sale of an underlying asset. Such guidance will likely arise in connection with the newly proposed revenue recognition standard.) Both boards

affirmed the application of an ROU model for all long-term lease arrangements of specified assets. A specified asset can be explicitly or implicitly identifiable, whether as a separate asset or as a physically distinct portion of a larger asset over which the lessee has exclusive use. These definitions of specified asset and control are slightly less broad than current GAAP, so fewer contracts will be considered leases (notably, the dividing line between leases

and service contracts will change). The ROU model will not, however, apply to the following:

- Short-term leases of 12 months or less, except by election
- Leases of intangibles
- Leases for the right to explore and use nonregenerative resources
- Leases of timber and other biological assets
- Leases of service concession arrangements.

Short-Term Leases and Lease Renewals

Capitalized lease accounting is meant to apply to long-term lease arrangements, not

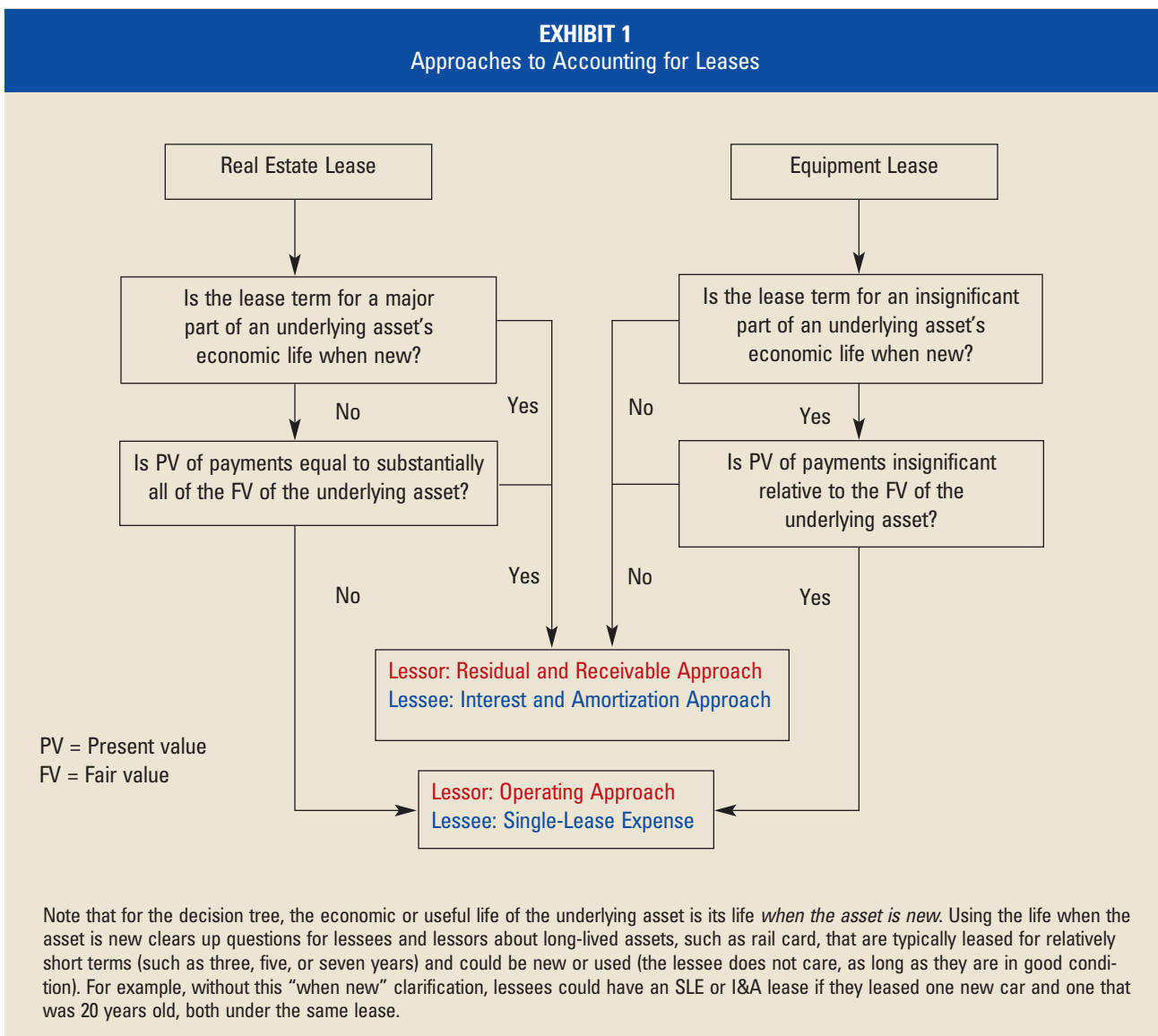
to short-term ones—that is, arrangements that, at the date of commencement, have a maximum possible lease term (including any options to renew or extend) of 12 months or less. Under the new model, lessees can either account for payments under these short-term arrangements as an operating expense or as capitalized amounts. Lessors may elect, as an accounting policy for a class of assets, to account for all short-term leases similar to today’s operating leases. Renewals with terms of 12 months or less are considered short-term leases (eligible for off-balance sheet operating lease accounting) where both the lessee and lessor have the right to terminate the renewal without significant penalty.

(This means that typical fleet/spilt TRAC/synthetic leases that have 12-month terms and month-to-month termination/renewal options will not be considered short-term leases. This also means that renewals of most leases will be operating leases [not capitalized, i.e., off-balance sheet].)

Types of Long-Term Leases

FASB and the IASB decided that there are only two types of leases—a real estate lease and an equipment lease—and each type should use an accounting approach that best depicts the economic consequence of the lease contract. *Exhibit 1* illustrates the approaches required for each type of

EXHIBIT 1
Approaches to Accounting for Leases



lease. For real estate leases, the lessor will most likely use an operating lease approach, whereas the lessee will most likely follow a single-lease expense (SLE) approach. For equipment leases, the lessor will most likely follow a residual and receivable (R&R) approach, whereas the lessee will most likely follow an interest and amortization (I&A) approach. (Many critics believe that the economic consequences of an equipment lease will not be accurately portrayed by the lessee following the I&A approach [the front-ended cost model].)

The operating lease approach is the same as operating lease accounting under the existing rules, whereas the R&R approach by the lessor is a new method that will replace the existing direct finance lease accounting. Under the R&R approach, the lessor will be required to immediately

record a profit, if any, on the lease of the ROU asset and to defer any related profit on the residual. Over the lease term, the lessor will accrete the initially recorded residual to the expected future value of the residual and amortize the receivable using effective interest amortization.

Unlike the lessor, the lessee has no operating lease accounting option and must record an ROU asset and lease liability at lease commencement. Subsequently, two alternative approaches are used to amortize the ROU asset and lease liability. The lessee will use either the I&A approach (i.e., the financing approach) or the SLE approach (i.e., the straight-line approach), depending upon whether the lease is for equipment or real estate, respectively. (The names for the lessee approaches have gone through several iterations and are not yet "official." The nomenclature used here is

from the July 2012 IASB/FASB board meeting discussion papers, because these names are most likely to be used in the exposure draft.) Under the I&A approach, the ROU asset and lease liability are set up at the present value of the future lease payments, and then subsequently are amortized separately over the lease term. (It should be noted that leases viewed as financed purchases under the revenue recognition project will not be considered leases.) The reported lease cost is the sum of the asset depreciation and the effective interest on the liability. Under the SLE approach, the reported lease cost is the average rent accrued over the lease term (much the same as the operating lease under existing GAAP), and the ROU asset and lease liability are adjusted as of each balance sheet date to be the present value of the remaining lease payments. (The SLE approach appears to include substantive underpinnings from the proposed revenue recognition standard, which would not view a lease contract as a financing transaction. In other words, amortization of the liability separate from amortization of the asset, as in a financing arrangement, would not be appropriate. In the authors' opinion, the I&A approach for equipment leases fails to view the ROU lease as an executory contract, and thus it is contrary to the legal status of an equipment lease.) The lease term, for both lessees and lessors, is the noncancellable contract period, adjusted for any significantly incentivized option to extend or terminate the contract length.

Lessor Accounting

As shown in Exhibit 1, lessor accounting will take either an operating approach or an R&R approach, depending upon whether the lease is considered a financing arrangement. If the lease is not considered to be a financing arrangement, the lessor will record an operating lease. Real estate leases are presumed to be operating leases unless the lease term is for a major part of the underlying asset's economic life when new, or the present value of payments equals substantially all the fair value of the underlying asset. The only financial effect will be the recording of rental receipts as under existing operating lease accounting.

If the lease is considered to be a financing arrangement, the lessor will use

EXHIBIT 2:

Lessor Accounting under the Receivable and Residual (R&R) Approach

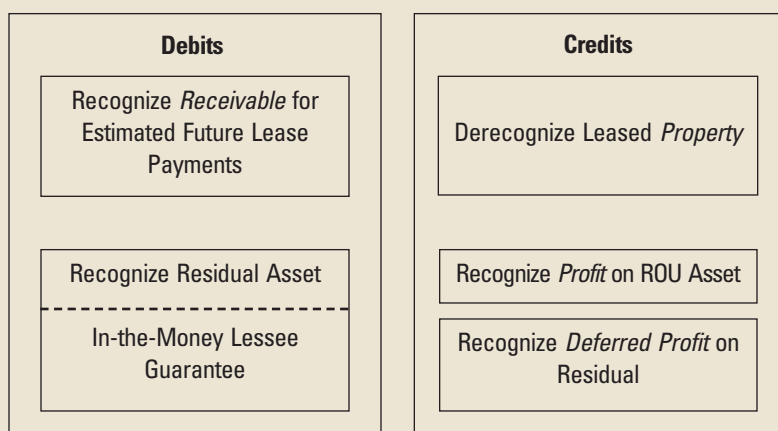


EXHIBIT 3

Calculation of Profit on ROU Asset and Deferred Profit on Residual Asset

When Fair Value (FV) Is Greater Than Book Value (BV)

Step 1: Calculate Gross Profit (GP)

$$GP = FV \text{ of Leased Asset} - BV \text{ of Leased Asset}$$

Step 2: Calculate Profit on ROU Asset

$$\text{Profit on ROU Asset} = GP \times (\text{Lease Payments Receivable} \div FV \text{ of Leased Asset})$$

Step 3: Calculate Deferred Profit on Residual

$$\text{Deferred Profit on Residual} = GP - \text{Profit on ROU Asset}$$

the R&R approach for all leases to one lessee of an entire asset or a physically distinct portion of a larger asset. Equipment leases are presumed to be financing leases, unless the lease term is for an insignificant part of the underlying asset's economic life when new or the present value of payments is insignificant relative to the fair value of the underlying asset. (As an exception, short-term leases may be accounted for using the current GAAP operating lease method, which produces an accounting result that is almost the same as the accounting for a direct finance lease under Statement of Financial Accounting Standard [SFAS] 13, *Accounting for Leases*.) As shown in *Exhibit 2*, any sales-type gross profit from the lease is attributed partly to the receivable and partly to the residual. The profit attributed to the receivable is recognized at lease commencement, whereas the profit

attributed to the residual is deferred until disposition of the residual.

Under the R&R approach, assets are 1) the receivable calculated as the present value of the estimated lease payments—the minimum lease payment for the lessor does not include any guaranteed residual value when the lessee is not entitled to the residual profits on the residual and does not include any bargain purchase option, only the lessee's required lease payments are included—using the rate the lessor charges the lessee (generally, the implicit rate in the lease for equipment leases), and 2) the residual derived by subtracting the receivable from the book value of the underlying leased asset, plus any profit and deferred profit. Put another way, the residual is the difference between the receivable and the fair value of the underlying leased asset. Although this residual value amount initially represents an allo-

cation of the carrying amount of the underlying leased asset, it will always equal the present value of the future expected residual. At the lease commencement, and each reporting period thereafter, the fair value of the underlying asset's utility will be represented partly in the receivable balance and partly in the residual balance.

When the underlying leased-asset fair value is equal to its book value, there is no sales-type gross profit on the lease. As shown in *Exhibit 3*, when the underlying leased asset fair value is greater than its book value, a profit must be recognized. The recognition of gross profit, however, is limited to the profit on the ROU asset transferred, calculated by multiplying the total gross profit by the percentage derived by comparing the present value of the lease payments receivable to the fair value of the underlying leased asset. The remainder of any gross profit is attributed to the residu-

EXHIBIT 4
Comparison of Income Flow under Old and New Accounting by the Lessor

Year	Current Rules				Percentage Difference	New Rules				
	Lease Payment	Depreciation*	Profit†	Total		Total	Profit	Interest Income (Accretion)	Interest Income (Receivable)	Deferred Profit‡
1	\$103,631	(\$70,000)	–	\$33,631	62%	\$54,605	\$14,896	\$12,250	\$27,459	–
2	\$103,631	(\$70,000)	–	\$33,631	3%	\$34,596	–	\$13,231	\$21,365	–
3	\$103,631	(\$70,000)	–	\$33,631	(14%)	\$29,073	–	\$14,289	\$14,784	–
4	\$103,631	(\$70,000)	–	\$33,631	(31%)	\$23,108	–	\$15,432	\$7,676	–
5	\$103,631	(\$70,000)	(\$5,000)	\$28,631	(24%)	\$21,771	–	\$16,667	0	\$5,104
				\$163,155		\$163,153				

Note: Figures have been rounded.

* Depreciation = $(\$580,000 - \$90,000) \div 7 = \$70,000$ per year. Alternatively, in practice some lessors depreciate to the residual as salvage using the lease term as the depreciable life $(\$580,000 - \$225,000) \div 5 = \$71,000$.

† Asset beginning book value (BV) \$580,000

Accumulated depreciation $(5 \times \$70,000)$ \$350,000

BV at end of lease term \$230,000

Disposal for expected fair value (FV) \$225,000

Loss on sale of residual asset \$ 5,000

‡ Assuming the residual is sold at the end of lease term for its expected FV.

AN EXAMPLE OF R&R EQUIPMENT LEASE ACCOUNTING BY THE LESSOR

The typical accounting entries recorded by the lessor include the following: 1) commencement of the lease, 2) accretion of the residual, 3) receipt of lease payments, and 4) lease expiration. As an illustration of the lessor's accounting entries and calculations, assume that the lessor company negotiates an equipment lease with the following facts:

- Fair value (FV) of leased asset is \$600,000
- Book value (BV) of leased asset is \$580,000
- Lessor's implicit rate of return is 8%
- Lease term is 5 years
- Asset life is 7 years
- The estimated residual value at the end of 5 years is \$225,000; at the end of 7 years, it is \$90,000 (salvage value for book depreciation)
- Lessee guarantees \$200,000 of ROU asset's residual value but is not entitled to residual gains
- Payments by the lessee are made "in advance."

Analysis of the Lease

Is the lease term for an insignificant part of underlying asset's economic life? No

Is the present value (PV) of lease payments insignificant relative to the FV of the underlying asset? No

As a result, use the residual and receivable (R&R) approach.

Commencement of the Lease

Lessor computes lease payments receivable and the residual

Fair value of leased asset	\$600,000
<i>Residual:</i> PV of expected residual (\$225,000 at 8% for 5 years)	<u>\$153,131</u>
<i>Receivable:</i> Amount to be recovered from lease payments	<u>\$446,869</u>

Lessor computes the lease payment to be paid by lessee

Note: The Lessor does not include any residual value guarantees by the lessee or any bargain purchase option in the lease payments calculation.

Required lease payments:

(Annuity due at 8% for 5 years with a PV of \$446,869) = \$103,630.76

Note: This lease example simplifies the lessor's payment calculation by excluding any bargain/compelling renewals, estimates of variable payments based on an index or rate, and any estimated in-the-money guaranteed residual. For example, if the payment depends on an index or rate (variable payment), it should be initially measured using the index or rate at lease commencement, and then subsequently reassessed at the end of each reporting period. Resulting changes in the lease payments receivable are recorded to interest expense for the current period portion and to the ROU asset for the future portion of the adjustment.

Because the leased asset FV is greater than the BV, compute profit and deferred profit

Step 1: Gross profit = FV - BV = \$600,000 - \$580,000 = \$20,000

Step 2: Profit on sale of ROU asset = GP × (Lease receivable ÷ FV of leased asset)

Profit on sale of ROU asset = \$20,000 × (\$446,869 ÷ \$600,000) = \$14,896

Step 3: Deferred profit on residual = GP - Profit on ROU Asset

Deferred profit on residual = \$20,000 - \$14,896 = \$5,104

Note: A higher portion of the gross profit is deferred when the guaranteed residual value is part of the residual asset, rather than part of the receivable.

Accounting entry, beginning of Year 1

Lease Payments Receivable	446,869	
Residual ROU Asset	153,131	
Profit on Sale of ROU Asset		14,896
Deferred Profit on Residual		5,104
Inventory - ROU Asset		580,000

Note: Deferred profit should be reported on the balance sheet net of the residual asset.

(Continues on page 22)

al and is deferred and not recognized in income until the residual is sold or re-leased, or until payment is demanded under a residual guarantee. The deferral of any sales-type gross profit means less up-front profit will be recognized as compared to existing GAAP. When the leased asset's fair value is less than its book value, a loss must be recognized on the ROU asset transferred, with no portion of it deferred on the residual. The entry on the lessor's books for recording the transfer of the leased asset to the lessee is as follows:

Lease Payments Receivable	XX
Residual Asset	XX
Profit	XX
Deferred Profit	XX
Leased Asset	XX

Where the following accounts are measured at the following amounts:

Lease Receivable	Present value of cash flows from lessee
Residual Asset	Plug figure or present value of expected future residual value
Profit	Refer to Exhibit 3
Deferred Profit	Refer to Exhibit 3
Leased Asset	Lessor's book value

During the lease term, the residual is accreted to its expected fair value using the implicit rate in the lease. Accretion of the residual will result in recording interest revenue over the lease term. This interest revenue represents accretion in the residual's initial value to its expected fair value at the conclusion of the lease. At the end of the lease term, the ROU residual asset is either sold either to a third party or re-leased. One of these events must occur before any deferred profit from the commencement entry can be recognized.

Possible cash payments from a guaranteed residual value or from a bargain purchase option will not be included in the minimum lease payment, and thus will not be included in the receivable because of the following:

■ Bargain purchase option lease arrangements will likely be outside the scope of the new accounting rules and will be treated as a financing and purchase of the underlying asset. (FASB and the IASB are likely to scope out such leases because the newly proposed revenue recognition standard would consider those contracts loans to purchase the underlying asset.)

■ Any guaranteed residual value by the lessee will be ignored by the lessor until the lessor files a claim.

Under the new lease accounting rules, there will always be a residual on the lessor's books, regardless of whether all or a portion of it is guaranteed by the lessee. Because the minimum lease payment, and thus the receivable, no longer includes the guaranteed residual value, the guarantee is now shifted away from the receivable balance and into the residual asset balance; as seen in the sidebar, *An Example of R&R Equipment Lease Accounting by the Lessor*, this will result in a higher portion of the gross profit being deferred. In addition, this means the guaranteed residual is not a financial asset that can be securitized off the balance sheet. Subsequent adjustment for impairment of the expected residual value will reset the accretion schedule starting with the book value at the reassessment point and then accreting to a new expected fair value at the end of the lease term by using an imputed rate of return.

The sidebar illustrates the typical accounting entries for a lessor.

Comparison of Results under Old and New Accounting by Lessor

Under existing GAAP, the equipment lease described in the sidebar would be an operating lease because none of the four criteria for capitalization can be met. This would mean that the leased asset remains on the lessor's books, the asset is depreciated over its useful life, and the lease payments received from the lessee represent rental income. Under the new rules, if this was a real estate lease where the term is *not* for a major part of the useful life and the present value of the payments is *less than* substantially all of the fair value of the leased asset, or if the equipment lease has an insignificant present value or life relative to the underlying asset, it would continue to be accounted for as an operating lease. Because the lease in the sidebar is an equipment lease that does not have an insignificant value or life relative to the underlying asset, the leased asset will be *replaced* on the lessor's books by a receivable and residual. The amortization of the receivable and the accretion of the residual will create a relatively higher income flow in the earlier part of the lease term. This distinction in income flow between the old

and new rules is shown in *Exhibit 4*. Note that the new rules will produce a 62% higher income in the first year.

Lessee Accounting

Unlike the lessor, the lessee can no longer record an "operating lease" for the long-term lease of an entire asset or a physically distinct portion of a larger asset. Instead, for leases that are not designed as short-term, the lessee will record an ROU asset and a liability for estimated future lease payments. In most cases, an ROU lease is legally an executory contract. The lessee acquires a temporary right to control the use of the underlying asset; it does not purchase or control an ownership interest in the property. This temporary acquisition is designated as the ROU asset. The liability for making lease payments is not a financing arrangement, and as a consequence, it is not equivalent to debt because the lessor has no claim on the assets of the lessee in bankruptcy. (This distinction is important for a potential new lender analyzing the company.) The lessee must make its rent payments to obtain future use of the underlying leased asset's utility. Contracting the right to use an asset that requires ongoing performance (i.e., paying rent) is not the same as purchasing the underlying leased asset, because the ROU asset typically cannot be pledged or sold separately from the corresponding liability.

The value on the balance sheet of the capitalized lease liability each period is the present value of the remaining payments using the lessee's incremental borrowing rate at commencement. If there are initial direct costs, they are debited to a subaccount of the ROU asset and amortized straight-line over the lease term, charged to rent expense. The lessee's liability includes all potential payments under the lease contract. This would include any "in the money" lessee guaranteed residual value or a bargain purchase option. (At lease commencement, it is not typical for the expected future value of the residual to be less than the lessee guarantee, because current guidance—FASB Interpretation Number [FIN] 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*—would require the present value of the difference to be recorded as a liability on the balance sheet.

AN EXAMPLE OF R&R EQUIPMENT LEASE ACCOUNTING BY THE LESSOR

(Continued from page 20)

Accretion of the Residual ROU Asset

Prepare an accretion schedule

Step 1: Initial residual value = Present value of expected residual

Initial residual value = \$153,131

Step 2: End residual value = Expected FV of \$225,000

Step 3: Accretion Table:

Year	Beginning Residual Value	Accretion Amount (Interest Income at 8%)	Ending Residual Value
1	153,131	12,250	165,381
2	165,381	13,231	178,612
3	178,612	14,289	192,901
4	192,901	15,432	208,333
5	208,333	16,667	225,000

Note: The ending residual value should not be net of the lessee's guarantee, because under the new rules, the lessee guarantee will not be included in the minimum lease payment, hence the receivable.

Accounting entry, end of Year 1

Residual ROU Asset	12,250	
Interest Income		12,250

Receipt of Lease Payments

Determine the amortization of the lease payments receivable

Amortization of the receivable at 8% over the 7-year lease life (figures are rounded):

Year	Beg. of Year Receivable Balance	Payment Received	Interest Income	Reduction in Receivable	Adjusted Receivable Balance
1	446,869	103,631		103,361	343,238
2	343,238	103,631	27,459	76,172	267,066
3	267,066	103,631	21,365	82,265	184,801
4	184,801	103,631	14,784	88,847	95,954
5	95,954	103,631	7,676	95,954	0

Accounting entries, end of Year 1 and beginning of Year 2

Interest Receivable	27,459	
Interest Income		27,459
Cash	103,631	
Interest Receivable		27,459
Lease Payments Receivable		76,172

Lease Expiration

Asset returned to lessor

Inventory—ROU Asset	225,000	
Residual ROU Asset		225,000

Sale of residual to third party for estimated FV

Cash	225,000	
Deferred Profit on Residual	5,104	
Inventory—ROU Asset	225,000	
Profit on Sale		5,104

Sale of residual for less than estimated FV, but more than lessee guarantee

The sale to a third party is for \$210,000 cash. A loss is recorded on the sale of $(\$225,000 - \$210,000) - \$5,104$ deferred profit.

Cash	210,000	
Loss on Sale of Residual Asset	9,896	
Deferred Profit on Residual	5,104	
Inventory—ROU Asset		225,000

Sale of residual for less than estimated FV and less than lessee guarantee

The sale to a third party is for \$190,000 cash, with demand for payment from lessee of \$10,000 $(\$200,000 - \$190,000)$ for guarantee of residual value. A loss is recorded on the sale as $(\$225,000 - \$200,000) - \$5,104$ deferred profit.

Cash	\$190,000	
Receivable from Lessee for GRV	\$ 10,000	
Loss on Sale of Residual Asset	\$ 19,896	
Deferred Profit on Residual	\$ 5,104	
Inventory—ROU Asset		\$225,000

It is more likely for the guarantee to be in-the-money as the lease approaches expiry.)

This treatment is unlike the calculation of the receivable on the lessor's books, which specifically excludes any guarantees by the lessee or bargain purchase options. Although this potential nonparallel treatment could make the lessee's liability greater than the lessor's receivable, the respective balances reflect the economic value to each party. For the lessor, the receivable represents the utility of the underlying asset that is sold to the lessee (the residual represents the unsold utility). For the lessee, the liability to make payments represents the right to future access of the ROU asset's utility, including the utility from any in-the-money guaranteed residual or bargain purchase option.

Under existing GAAP, the "capital lease" recorded for a long-term lease would separate the asset from its related liability and require that the leased asset be depreciated over the lease term and that the liability be amortized using effective interest amortization. In other words, the lease is treated as a financing arrangement. Under the new rules (as shown in Exhibit 1), only a real estate lease that is *for a significant* part of the underlying asset's value or economic life or an equipment lease that is *not for an insignificant* part of the underlying asset's value or economic life would continue this capital lease treatment, now to be called the I&A approach by the FASB/IASB.

The new SLE approach will be used for a real estate lease that is *not for a significant* part of the underlying asset's value or economic life or an equipment lease that is *for an insignificant* part of the underlying asset's value or economic life. Lessees using the SLE approach will treat the ROU asset and its related liability together as one unified contract. The ROU asset will be accounted for as part of an executory contract whose initial size and subsequent amortization is determined by the lessee's liability to make payments, not by the use of the underlying leased asset. Accordingly, the ROU asset and lease liability will be adjusted in unison on each balance sheet date to equal the present value of the remaining lease payments (computed at the lessee's incremental borrowing rate).

Meanwhile, the income effect will mirror the cost pattern under existing GAAP for operating leases—that is, a constant rent expense over the lease term. Keeping a cost pattern consistent with existing operating leases preserves the presentation of rental costs as part of operating income in the income statement and as operating cash flow in the statement of cash flows. These new lessee approaches mean that most real estate leases will use the SLE approach, and, thus, will have a uniform cost pattern over the lease term. Conversely, most equipment leases will use the I&A approach, and, thus, will have front-loaded lease costs (because existing practice for most equipment leases is to use operating lease accounting, the new I&A approach will most likely cause equipment lessees to continue to keep records under existing rules for legal and tax purposes).

Impairment

As a lease approaches expiry, the ROU asset may become impaired. If impairment occurs, the following two possible outcomes exist:

- The usefulness of the underlying asset to the lessee can remain unaffected or be diminished.
- An in-the-money lessee guarantee may be created from a change in the expected future residual value. A change in expected residual value is a change in assumptions, in this case precipitated by impairment.

If the ROU asset's usefulness (utility) to the lessee is diminished, the ROU asset is written down by creating a contra asset account (ROU—Impairment) that is amortized straight-line over the remaining lease term as a credit to amortization expense under the I&A approach or as a credit to rent expense under the SLE approach. The write-down of the ROU asset via the contra account allows the impairment loss to be taken in the period it occurs, while the subsequent amortization of the contra account allows the net amortization or rent expense to reflect the underlying asset's lowered usefulness to the lessee. In addition, a contra asset account is used under the SLE approach so that the ROU asset balance can continue to be calculated each period, along with the liability balance, as the present value of the lessee's payments over the remain-

ing lease term. To maintain identical balances for the ROU asset and lease liability, any initial direct costs should be debited to "ROU—Initial Direct Costs" (a sub-account of the ROU asset) and subsequently should be amortized to rent expense. Under the I&A approach, a reduction of the ROU asset would accomplish the same result as using a contra account.

If events subsequent to the lease commencement cause a significant change in the expected future residual value, and this change in value produces in-the-money lessee guaranteed residual value, the liability and ROU asset balances must be adjusted from the point of change (under both approaches). This change should be reflected prospectively by including the present value of the in-the-money amount, together with the present value of the remaining lease payments, when determining the balance sheet value of the capitalized lease liability (and the ROU asset under the SLE approach). This present value calculation would continue to use the lessee's incremental borrowing rate at lease commencement.

Under the I&A approach, the newly amended lease liability amortization schedule will be used for determining interest expense over the remaining lease term, and the adjusted ROU asset amount will be depreciated over the remaining term. Under the SLE approach, the adjustment of the residual guarantee will be included in total rent expense to be accrued straight line over the remaining lease term. This will be accomplished by debiting rent expense by a constant amount each period. Accretion is used instead of initially setting up a liability and deferred rent expense for the full in-the-money amount, because the net liability under the lease contract would be overstated since the present value of the in-the-money amount is already included in the lease liability and ROU asset. Accreting the amount makes the net liability higher than the ROU asset balance each year of the accretion until expiry, when the difference will equal the liability for the in-the-money lessee guarantee.

The sidebar, *An Example of Lease Accounting by the Lessee*, illustrates the typical accounting entries for a lessee.

AN EXAMPLE OF LEASE ACCOUNTING BY THE LESSEE

The typical accounting entries recorded by the lessee include the following: 1) commencement of the lease, 2) year-end adjustment of the ROU asset and liability balances to present value (PV), 3) lease payments, and 4) lease expiration. In addition, during the lease term, the ROU asset could be impaired. To illustrate the lessee's accounting entries and calculations, the same lease facts from the lessor example are used. It is assumed that the lessee's incremental borrowing rate is equal to the lessor's implicit rate.

Commencement of the Lease (under Both Approaches)

Lessee Computes Liability for Lease Payments and ROU Asset

PV of the \$103,630.76 lease payments over 5 years at 8% = \$446,869

Note: PV is computed using the lessee's incremental borrowing rate. The PV of the lessee's liability is the same amount as the lessor's receivable, because, in this example, the lessee's incremental rate is equal to the lessor's implicit rate. This example does not have any in-the-money lessee guaranteed residual value at commencement. If it did, the liability and ROU asset would be increased by the PV of the amount by which the lessee's guarantee exceeded the expected future residual value. An in-the-money amount would also increase the rent expense by a constant amount each period that accretes the liability for residual guarantee to a balance equal to the in-the-money guarantee.

Liability to make lease payments = \$446,869

ROU asset = \$446,869

Accounting entry, beginning of Year 1

ROU Asset	446,869	
Liability for Lease Payments		446,869

Year-End Adjustment of ROU Asset and Liability Balances

Using the I&A Approach

Lessee prepares amortization schedules for the liability and ROU asset

Amortization of the liability at 8% over the 5-year lease life:

Year	Beg. of Year Liability Balance	Payment	Interest Expense	Reduction in Liability	Adjusted Liability Balance
1	\$446,869	\$103,631		\$103,361	\$343,238
2	\$343,238	\$103,631	\$27,459	\$76,172	\$267,066
3	\$267,066	\$103,631	\$21,365	\$82,265	\$184,801
4	\$184,801	\$103,631	\$14,784	\$88,847	\$95,954
5	\$95,954	\$103,631	\$7,676	\$95,954	0*

* When the lease expires, even though the underlying leased asset may have a residual value when returned to the lessor, from the lessee's perspective the right-to-use has expired and so has the obligation to pay for it. The balances of the ROU asset and its related liability should be zero at the lease expiry, except for any in-the-money lessee guarantee previously anticipated. The payable and related income effect is booked if and when demand is made for payment of the lessee guarantee.

Amortization of ROU asset:

Straight-line amortization = (\$446,869 ÷ 5 years = \$89,374 per year

Accounting adjusting entries, end of Year 1 (or beginning of Year 2)

Interest Expense	27,459	
Liability for Lease Payments	76,172	
Cash		103,631
Amortization Expense	89,374	
ROU Asset		89,374

Using the SLE Approach

Lessee prepares an amortization schedule for the Liability and related ROU Asset

Amortization of the liability and ROU Asset at 8% over the 5-year lease life:

Year	Beg. of Year Liability and ROU Asset Balance	Payment	Offsetting Interest Element	Reduction in Liability and ROU Asset	Adjusted Liability and ROU Asset Balance
1	\$446,869	\$103,631		\$103,361	\$343,238
2	\$343,238	\$103,631	\$27,459	\$76,172	\$267,066
3	\$267,066	\$103,631	\$21,365	\$82,265	\$184,801
4	\$184,801	\$103,631	\$14,784	\$88,847	\$95,954
5	\$95,954	\$103,631	\$7,676	\$95,954	0*

* When the lease expires, even though the underlying leased asset may have a residual value when returned to the lessor, from the lessee's perspective the right-to-use has expired and so has the obligation to pay for it. The balances of the ROU asset and its related liability should be zero at the lease expiry, except for any in-the-money lessee guarantee previously anticipated. The payable and related income effect is booked if and when demand is made for payment of the lessee guarantee.

Accounting adjusting entry, end of Year 1 (or beginning of Year 2)

Liability for Lease Payments	76,172	
ROU Asset		76,172
Rent Expense*	103,631	
Rent Payable		103,631
Rent Payable	103,631	
Cash		103,631

* In the case of uneven lease payments, the average lease payment is accrued.

(Continues on page 26)

Comparison of Results under Old and New Accounting by Lessee

Under existing GAAP, the example equipment lease arrangement discussed in the sidebar would be an operating lease, because none of the four criteria for capitalization can be met. As a result, the rent expense payments by the lessee would represent the only effect on the lessee's books. Under the proposed guidance, an ROU asset and its related liability would appear on the balance sheet.

If the SLE approach could be used, both the ROU asset and liability would be amortized to their present value at the end of each reporting period. This would have no effect on income. The only effect on income under the SLE approach would be the same rent expense as under an existing operating lease.

The SLE approach, however, will not be allowed with the equipment lease used in the example. Given that the present

value of lease payments is not insignificant relative to the fair value of the underlying asset, and the lease life is not an insignificant part of the underlying asset's life, an I&A approach will be required under the new lease rules. Using this approach, the lease will have a front-loaded cost pattern as shown in the sidebar. This approach will require separate asset amortization and liability amortization that will cause the combined income effect to have an accelerated cost early in the lease term and a diminished cost later.

If the example had been a capital lease under the existing rules—that is, if the terms of the lease allowed it to meet at least one of the four criteria for capitalization—the pattern of effect on income would be the same as under the newly required I&A approach.

The need to structure a lease arrangement to avoid capitalization will disappear under the proposed guidance. For the

lessee, all leases will be capitalized. Reporting transparency is improved with a matching of expense to the benefit from use, and the presence of a lease asset and a lease liability on the balance sheet. (Matching might not occur with most equipment leases, which will have to follow the I&A approach. Since these are executory contracts, the cost for use of the ROU asset comes from the lease payments, not from the separate amortization of the lease liability and ROU asset.) Although the criticism of off-balance sheet accounting will be alleviated by the guidance, there will be a potential downside for equipment lessees due to the front-loaded cost pattern created by the I&A approach.

Transition

For lessees, existing capital leases will be grandfathered. All operating leases must be capitalized with a lease liability and an ROU asset recorded equal to the present

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AN EXAMPLE OF LEASE ACCOUNTING BY THE LESSEE

(Continued from page 24)

Comparison of Lease Cost under Both Approaches

	Year 1	Year 2	Year 3	Year 4	Year 5
<i>I&A Approach</i>					
Interest	\$ 27,459	\$ 21,365	\$ 14,784	\$ 7,676	0
Amortization	\$ 89,374	\$ 89,374	\$ 89,374	\$ 89,374	\$ 89,374
Total	\$116,833	\$110,739	\$104,158	\$ 97,050	\$ 89,374
<i>SLE Approach</i>					
Average Payment	\$103,631	\$103,631	\$103,631	\$103,631	\$103,631

Lease Expiration

Asset Returned to Lessor

No entry required. ROU Asset and Liability balances are zero.

Lessor Sells Residual to Third Party for Less Than Amount Guaranteed by Lessee

Sale is to third party for \$190,000 cash, with demand for payment from lessee of \$10,000 (\$200,000 – \$190,000) for guarantee of residual value. When demand for payment is received:

Loss on Guarantee of Lease Residual	10,000	
Payable to Lessor		10,000

Impairment

Assume \$75,000 impairment of the ROU asset at the beginning of Year 3

The impairment loss should be credited to the contra asset account "ROU-Impairment" and subsequently amortized straight-line as a credit to rent expense under the financing approach and a credit to the ROU amortization expense under the SLE approach.

Record Impairment

Impairment Loss	75,000	
ROU-Impairment		75,000

Amortization at end of Year 3

\$75,000 spread over years 3, 4, and 5. $\$75,000 \div 3 = \$25,000$.

Entry under the I&A Approach:

ROU Impairment	25,000	
Rent Expense		25,000

Entry under the SLE Approach:

ROU Asset	25,000	
Amortization Expense		25,000

Assume a change in expected future residual value from \$225,000 to \$180,000 at the beginning of Year 3.

Find the in-the-money guaranteed residual value:

Guaranteed residual	200,000
New expected future residual value	180,000
In-the-money guarantee	20,000

Find the present value (PV) of in-the-money guaranteed residual value:

PV of \$20,000 at 8%, 3 years = \$15,876.64

Under the I&A Approach

Adjust the amortization schedule above by adding the PV of the guarantee to the beginning Year 3 balance for liability:

Year	Beg. of Year Liability Balance	Payment	Interest Expense	Reduction in Liability	Adjusted Liability Balance
1	\$446,869	\$103,631		\$103,361	\$343,238
2	\$343,238	\$103,631	\$27,459	\$ 76,172	\$267,066
3	\$267,066 + \$15,877	\$103,631	\$21,365	\$ 82,265	\$200,678
4	\$200,678	\$103,631	\$16,054	\$ 87,577	\$113,101
5	\$113,101	\$103,631	\$ 9,048	\$ 94,583	\$ 18,519
6	\$ 18,519	\$20,000*	\$ 1,481	\$ 18,519	0

* The \$20,000 balance represents the liability for in-the-money residual value.

New adjusting entry for the end of Year 3 (or beginning of Year 4):

Interest Expense	16,054	
Liability for Lease Payments	87,577	
Cash		103,631

Under the SLE Approach

In three years, at lease expiry, the liability for residual value guarantee will have accreted to a balance of \$20,000—the in-the-money amount. The annual adjustment to accrued rent over the remaining lease term:

Rent Expense (1/3 of \$20,000)	6,666.67	
Rent Payable		6,666.67

Adjust the Amortization Schedule from above by adding the PV of the guarantee to the beginning Year 3 balance for liability and ROU asset:

Year	Beg. of Year Liability and ROU Asset Balance	Payment	Offsetting Interest Element	Reduction in Liability and ROU Asset	Adjusted Liability and ROU Asset Balance
1	\$446,869	\$103,631	—	\$103,361	\$343,238
2	\$343,238	\$103,631	\$27,459	\$ 76,172	\$267,066
3	\$267,066 + \$15,877	\$103,631	\$21,365	\$ 82,265	\$200,678
4	\$200,678	\$103,631	\$16,054	\$ 87,577	\$113,101
5	\$113,101	\$103,631	\$ 9,048	\$ 94,583	\$ 18,519
6	\$ 18,519	\$20,000*	\$ 1,481	\$ 18,519	0

* The \$20,000 balance represents the liability for in-the-money residual value.

Demand for payment received from the lessor:

Rent Payable	20,000	
Cash		20,000

Note: This entry represents the cash payment shown in the amortization schedule for the in-the-money guarantee.

value of the remaining rents using the current incremental borrowing rate. For sale-leasebacks, if the leaseback is a capital lease it will be grandfathered and any gain will continue to be amortized to income statement. If the sale-leaseback is an operating lease, the original sale-leaseback assumptions must be reevaluated under current rules and rebooked using either the I&A or SLE approach, with any unamortized gain booked to equity. Whatever the case, a lessee will be able to choose full retrospective accounting for all its leases.

For lessors, existing direct finance and sales-type leases will be grandfathered. All operating leases will be treated as though they are new leases for their remaining term using one of the new lessor methods described earlier. For R&R leases, the existing lease book value will be derecognized while at the same time any profit and deferred profit, the present value of the expected residual, and the present value

of rents will be recognized. Leveraged leases will be booked as R&R leases, with the rents and debt reported at gross on the balance sheet and the earnings taken to date adjusted with an offset to equity.

Anticipating the Comments

The joint FASB/IASB lease accounting project has been more than six years in the making—but, ironically, we seem to be back to where we started. Except for lessee accounting of equipment leases, the rules are virtually the same as SFAS 13, with all but short-term leases capitalized. Even though the facts regarding leases have not changed since FASB issued SFAS 13 in 1976, the boards are about to issue a new exposure draft that emphasizes the symmetry of lessor and lessee accounting, disregarding the substance of most equipment leasing arrangements. As result, the authors predict that the main issue in most comment letters will be why equipment

leases are treated differently than real estate leases, when legally they involve the same obligations and transfer of a right of use. Standards should be based on principles, and the arbitrary rule that requires different treatment for equipment leases should be hard to defend. □

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