

Proposed Lease Accounting For Lessees

Stuart Shough, University of South Carolina Upstate, USA

ABSTRACT

On August 17, 2010, the Financial Accounting Standards Board and the International Accounting Standards Board jointly issued exposure drafts proposing a new accounting model for leases. This paper explains how a lessee would account for leases under this proposal.

Keywords: FASB proposed lease accounting

INTRODUCTION

Current procedure allows for certain assets to be defined by the method of financing. Many believe that an asset should be defined by its use; if it is a tool of production, it is an asset and should be so reported. A tool acquired under an operating lease currently is expensed and is not recognized for its functional reality, an asset.

Existing lease accounting standards require lessees to classify their lease contracts as either finance (capital) or operating leases. If a lease is classified as a finance lease, assets (and liabilities) are recognized in its statement of financial position. For an operating lease, the lessee simply recognizes lease payments as an expense over the lease term.

This split into finance and operating leases has given rise to a number of problems. Users complain that financial statements do not clearly depict the effects of operating leases. Many users think that operating leases give rise to assets and liabilities; therefore, they think lessees should recognize operating leases in their statement of financial position. Operating and finance leases are accounted for very differently, which reduces comparability for users. Users also complain that the standards provide opportunities to structure transactions so as to achieve a particular lease classification. Preparers and auditors have criticized the existing model for its complexity.

On August 17, 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft (ED), Leases, which creates a new accounting model for both lessees and lessors and will eliminate operating leases. The ED does not specify an effective date, but the board expects to issue a final standard in June 2011. This paper describes the accounting treatment under this ED.

NEW MODEL

Lessees would use the ‘right-of-use’ model. This model states that the lessee’s right to use the leased asset represents an asset and the lessee would record an intangible asset representing its right to use the leased asset for the lease term and a liability for the obligation to make lease payments.

The lessee would use its own incremental borrowing rate in determining the lease liability. The lease liability would be measured based on estimates of:

- The lease term
- Contingent rentals
- Expected payments under term option penalties and
- Residual value guarantees

The right-of-use asset would be amortized over the shorter of the lease term or its useful life. Lease payments would be allocated between interest expense and a reduction of the lease liability using the effective interest method. Lease payments would no longer be recognized as rental expense under the straight-line method.

For leases that have been classified as operating leases, rent expense will be replaced with amortization expense and interest expense.

Assets and liabilities would be reassessed each reporting period when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities.

Table 1 illustrates a simple lease for the lessee.

Table 1

Proposed Lessee Accounting Example	
Lease term	3 years
Annual lease payments	\$ 8,000
There are no contingent rentals, residual value guarantee or term option penalties	
Lessee's incremental borrowing rate	8%
Lease liability (present value of the lease payments)	\$ 20,617
Right-of-use asset (same as lease liability)	\$ 20,617

Table 2 shows the entries that the lessee would record for the inception of the lease and at the end of each year of the lease term.

Table 3 compares the results of the example in the income statement between the proposed accounting and an operating lease using existing accounting standards.

CONSEQUENCES

There would initially be an increase in assets and liabilities on the balance sheet for all leases previously accounted for as an operating lease. As for the income statement, the straight-line recognition of rental expense for operating leases would be replaced by the effective interest method's accelerated recognition of interest expense, together with amortization of the right-of-use asset.

Total lease-related expense will be front-end loaded causing net income to be lower in the early years of the lease term. The expenses would be greater than the lease payments in the early years and lower than the lease payments in the later years.

How this could affect financial leverage ratios:

- Assuming that total debt is less than total assets, the debt ratio would increase if assets and liabilities are increased by the same amount
- The debt-to-equity ratio would increase since total debt would increase and total equity would decrease.
- Since EBIT will decrease and interest charges will increase, the times interest earned ratio will decrease.

How this could affect profitability ratios:

- Return on assets would decrease due to a decrease in net income and an increase in total assets.
- Return on equity would decrease assuming net income and shareholder equity decrease by an equal amount.

Table 2

Journal Entries for the Proposed Lessee Accounting		
Entry at the inception of the lease		
Right-of-use asset	20,617	
Lease liability		20,617
Entries at the end of year 1		
Lease liability	6,351	
Interest expense	1,649	
Cash		8,000
Amortization expense	6,872	
Right-of-use asset		6,872
<i>Straight-line amortization (20,617 ÷ 3)</i>		
Entries at the end of year 2		
Lease liability	6,859	
Interest expense	1,141	
Cash		8,000
Amortization expense	6,872	
Right-of-use asset		6,872
Entries at the end of year 3		
Lease liability	7,407	
Interest expense	593	
Cash		8,000
Amortization expense	6,873	
Right-of-use asset		6,873

Table 3

Income Statement - Proposed vs Operating				
	Year 1	Year 2	Year 3	Total
Proposed lessee accounting				
Amortization of the right-of-use asset	\$ 6,872	\$ 6,872	\$ 6,873	\$ 20,617
Interest expense	1,649	1,141	593	3,383
	\$ 8,521	\$ 8,013	\$ 7,466	\$ 24,000
Existing operating lease accounting				
Lease expense	\$ 8,000	\$ 8,000	\$ 8,000	\$ 24,000

SCOPE

The guidance applies to all leases except leases of intangible assets, leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources and leases of biological assets.

The exposure draft does not apply to contracts that represent the purchase of an asset. A lease represents a purchase if at the end of the lease term the lessor transfers control of the asset and all but a trivial amount of the risks and benefits associated with the asset to the lessee. This is determined at the inception of the lease and is not subsequently reassessed.

A lease contract normally transfers control of an asset when the contract automatically transfers title to the asset to the lessee at the end of the lease term or includes a bargain purchase option.

The transfer of title of the asset would not be sufficient for a lessee to treat the lease as a purchase since all but a trivial amount of the risks and benefits must also be transferred to the lessee, but what constitutes a trivial amount? The exposure draft does not provide any specific guidance.

SHORT-TERM LEASES

The exposure draft provides simplified requirements to mitigate concerns about the cost of accounting for short-term leases. At the inception of a lease and subsequently, a lessee may elect to measure a short-term lease liability at the undiscounted amount of the lease payments and the right-of-use asset at the undiscounted amount of the lease payments plus initial direct costs. The lessee would just recognize lease payments in the income statement over the lease term.

THE LEASE TERM

The lease term is the longest possible term that is more than likely than not to occur. Leases that contain renewal options or options for early termination, the lessee will have to estimate the probability of occurrence for each possible term, for example, a lessee enters into a non-cancellable 5-year lease with two 5-year options to renew. The lessee assigns the following probabilities to each of the potential terms:

- A 40 percent probability of a 5-year term
- A 30 percent probability of a 10-year term
- A 30 percent probability of a 15-year term

The term will be at least 5 years. There is a 60 percent chance of a 10-year term or longer, but only a 30 percent chance of a 15-year term. The longest possible term more likely than not to occur is 10 years; therefore, the lease term is 10 years. This is clearly a subjective process.

Some considerations in assessing the probability of each possible lease term:

- Contractual factors such as termination penalties and the level of lease payment, for example, bargain renewal rates.
- Noncontractual factors such as the significant leasehold improvements.
- Business factors such as whether the leased asset is specialized for the lessee.
- Other lessee-specific factors such as past experience and the lessee's intentions.

DETERMINING THE PRESENT VALUE OF LEASE PAYMENTS

The lease liability would be measured based on estimates of:

- The lease term

- Contingent rentals
- Expected payments under term option penalties and
- Residual value guarantees

The present value of the lease payments will be determined on the basis of expected outcome. Estimating expected outcome involves:

- Identifying each reasonably possible outcome.
- Estimating the amount and timing of the cash flows for each reasonably possible outcome.
- Determining the present value of those cash flows.
- Estimating the probability of each outcome.

EXAMPLE OF DETERMINING LEASE PAYMENTS USING EXPECTED OUTCOME

The ABC Co. entered into a lease for retail space at a shopping mall. The lease is noncancelable for 10 years with two 5-year renewals. The annual lease payment is \$1 million per year plus an additional contingent rent of 2 percent of sales per year. The lease does not include a purchase option or residual value guarantee. The ABC Co.’s incremental borrowing rate is 8 percent.

The first step is to determine the lease term. The company determined the probabilities of each possible lease term based on contractual factors, the existence of leasehold improvements, and its past history of renewals.

The company assigned the probabilities to each of the potential terms (Table 4):

	<u>Two Renewals</u>	<u>One Renewal</u>	<u>No Renewal</u>
Lease term	20 years	15 years	10 years
Probability	40%	30%	30%
Cumulative probability	40%	70%	100%

The term will be at least 10 years. There is a 70 percent chance of a 15-year term or longer, but only a 40 percent chance of a 20-year term. The longest possible term more likely than not to occur is 15 years, therefore, the lease term is 15 years.

The next step is to determine the lease obligation over the expected lease term. This will be the present value of the annual lease payments and the expected outcome of the contingent rentals (Table 5). The exposure draft defines the expected outcome as is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes.

Based on the expected outcomes, the total amount of the lease obligation would be \$9,701,948, consisting of \$1,142,469 of contingent rentals and \$8,559,479 present value of the annual lease payments, as shown in Table 6. The cost of the right-of-use asset equals the lease obligation.

Table 7 reflects the journal entry that ABC Co. would make at the inception of the lease to record the right-of-use asset and the lease obligation.

If the actual sales for the first year are \$6,673,700, the company will make the journal entry shown in Table 8 to record the interest method amortization of the lease obligation. The right-of-use asset is amortized on a straight-line method. If sales were \$6,673,700 each year for the next 15 years, the amortization of the lease obligation would be reduced to zero with a rounding adjustment of \$5 as shown in Schedule 2.

Table 5

Expected Contingent Rentals--See Schedule 1					
	Outcome 1 Constant Sales	Outcome 2 Sales Growth 3% per year	Outcome 3 Sales Growth 5% per year	Outcome 4 Sales Decline 2% per year	Total
Total sales over 15 years, assuming \$6M in yr 1 plus growth/decline	\$ 90,000,000	\$ 111,593,483	\$ 129,471,382	\$ 78,429,269	
Total contingent rent*	1,800,000	2,231,870	2,589,428	1,568,585	
PV of total contingent rent	1,027,137	1,221,273	1,378,541	920,607	
Probability	45%	35%	15%	5%	
PV of the probability-weighted average of the cash flows	\$ 462,212	\$ 427,446	\$ 206,781	\$ 46,030	\$ 1,142,469
* Total contingent rent is the sales for each year times 2% summed for 15 years					

Schedule 1 Worksheet for Contingent Rentals

Growth/Decline		0.03		Beginning of the Year Sales Times Contingent Rate		=NPV formula
Year	Sales	Growth/Decline				
1	6,000,000	180,000	6,180,000	120,000		1,221,273
2	6,180,000	185,400	6,365,400	123,600		
3	6,365,400	190,962	6,556,362	127,308		
4	6,556,362	196,691	6,753,053	131,127		
5	6,753,053	202,592	6,955,644	135,061		
6	6,955,644	208,669	7,164,314	139,113		
7	7,164,314	214,929	7,379,243	143,286		
8	7,379,243	221,377	7,600,620	147,585		
9	7,600,620	228,019	7,828,639	152,012		
10	7,828,639	234,859	8,063,498	156,573		
11	8,063,498	241,905	8,305,403	161,270		
12	8,305,403	249,162	8,554,565	166,108		
13	8,554,565	256,637	8,811,202	171,091		
14	8,811,202	264,336	9,075,538	176,224		
15	9,075,538	272,266	9,347,804	181,511		
Total sales over the 15 years based on % growth/decline	111,593,483			2,231,870		1,221,273
				Total Contingent Rent based on Growth/Decline		Present Value Of Contingent Rentals

Table 6

Amount of Lease Obligation And Right-of-Use Asset	
Contingent rentals	\$ 1,142,469
Annual lease payments (PV of \$1M per year for 15 years)	8,559,479
Total lease obligation and right-of-use asset	\$ 9,701,948

Table 7

Journal Entry at the Beginning of Year 1		
Right-to-use asset	9,701,948	
Lease obligation		9,701,948

Table 8

Journal Entries at the End of Year 1 Based on \$6,673,700 Sales		
Lease obligation *	357,318	
Interest expense	776,156	
Cash		1,133,474
Amortization expense *	646,797	
Right-to-use asset		646,797
* See Schedule 2		
** 9,701,948 / 15 yrs		

Schedule 2

Amortization of Lease Obligation						
Year	Beginning Liability Balance	\$1,000,000 Annual Payment		2% Contingent Rent on \$6,673,700 *	Total Liability Reduction	Ending Liability Balance
		8% Interest Expense	Liability Reduction			
1	9,701,948	776,156	223,844	133,474	357,318	9,344,630
2	9,344,630	747,570	252,430	133,474	385,904	8,958,726
3	8,958,726	716,698	283,302	133,474	416,776	8,541,950
4	8,541,950	683,356	316,644	133,474	450,118	8,091,832
5	8,091,832	647,347	352,653	133,474	486,127	7,605,705
6	7,605,705	608,456	391,544	133,474	525,018	7,080,687
7	7,080,687	566,455	433,545	133,474	567,019	6,513,668
8	6,513,668	521,093	478,907	133,474	612,381	5,901,288
9	5,901,288	472,103	527,897	133,474	661,371	5,239,917
10	5,239,917	419,193	580,807	133,474	714,281	4,525,636
11	4,525,636	362,051	637,949	133,474	771,423	3,754,213
12	3,754,213	300,337	699,663	133,474	833,137	2,921,076
13	2,921,076	233,686	766,314	133,474	899,788	2,021,288
14	2,021,288	161,703	838,297	133,474	971,771	1,049,517
15	1,049,517	83,961	916,039	133,474	1,049,513	5
Totals		7,300,167	7,699,833		9,701,943	
		\$15,000,000 Lease Payments			\$5 Rounding	
		* \$133,474 / .02 = \$6,673,700		133,474	determined by trial and error	

Naturally, sales will not equal \$6,673,700 each year. Suppose sales at the end of year 1 are \$7,000,000. The exposure draft does not provide specific guidance as the account(s) to use in this case. As one possible solution, ABC Co. could use another contingent expense/income account. This account would be debited when sales are above \$6,673,700 and would be credited when sales are below that amount, and the cash account would be adjusted accordingly. This account would serve as a red flag for management. A large balance, debit or credit, could alert management that a reassessment of the expected contingent rentals might be needed. Table 9 reflects the journal entries based on this approach.

Table 9

Journal Entries at the End of Year 1 Based on \$7,000,000 Sales		
Lease obligation	357,318	
Interest expense	776,156	
Other contingent expense/income*	6,526	
Cash		1,140,000
Amortization expense	646,797	
Right-to-use asset		646,797
* Based on an additional \$326,300 sales times 2%		

A comparison between the proposed standard and the current standard for an operating lease is shown in Tables 10 and 11. The sales for the year are \$7,000,000. The expenses are front-end loaded for the proposed standard and are therefore higher in the early years than under the current standard causing net income to be less upon adoption of a final standard.

Table 10

Income statement Proposed Standard	Year 1
Amortization of the right-of-use asset	\$ 646,797
Interest expense	776,156
Other contingent expense/income	6,526
Total income statement expense	\$ 1,429,479

Table 11

Income statement Current Standard	Year 1
Rent expense	\$ 1,000,000
Contingent rent	140,000
Total income statement expense	\$ 1,140,000

LEASE INCENTIVES

The exposure draft does not address the following lease incentives:

- Payments by the lessor to the lessee to enter into the lease
 - Allowances provided by a lessor to a lessee for tenant improvements
- You should expect guidance on these topics when the final standard is issued.

AUTHOR INFORMATION

Stuart Shough has worked in the private sector for 12 years and has taught accounting for 27 years. He is currently Senior Instructor at the George Dean Johnson, Jr. College of Business and Economics at the University of South Carolina Upstate.

REFERENCES

Available from author