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Accountability and Accounting Standards: The Effect of Providing Indicative but Incomplete Guidance Rules

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Abstract

Purpose: This paper tests the interaction effects of education and accounting standard type (principles- or rules-based) for students who are exercising judgement in the face of accountability.

Method: An experimental model is employed in which the type of accounting standard is manipulated. The effect of the type of accounting standard is then compared for students in introductory and final year accounting courses.

Findings/Results: Our results indicate that the inclusion of indicative, but incomplete rules leads to increased conformance to pressure. Education improves the application of principles but incomplete rules continue to have a detrimental effect, even for students who have effectively completed their university studies.

Implications: This research is important in providing guidance to the regulatory bodies as they determine the extent to which guidance rules should be included in new and revised accounting standards. It is also important to educators as they consider the effect of their teaching on the students' application of professional judgement.

Keywords: Leases, accounting standards, judgement, accountability.

JEL classification: M41, M48

Introduction

An important feature of the international harmonisation of accounting standards is the intention to rely more heavily on principle-based standards (Tweedie 2007). One of the reasons given for this significant change in philosophy has been the failure of rules-based standards to prevent the misleading and fraudulent financial reporting that preceded many of the major corporate collapses in this decade (Satava, Caldwell, and Richards 2006). While identifying a number of advantages of providing rules, Nelson (2003) and Nobes (2005, 25) note that a relatively greater reliance on rules can lead to manipulation of financial statements. Preparers of financial statements may attempt to circumvent the underlying principles of the conceptual framework by carefully structuring transactions that satisfy the letter, but not the spirit, of the accounting standard. Therefore, in this move toward a principle-based approach an important issue that remains unanswered is whether indicative rules should be included in principle-based accounting standards.

There is an argument that a reliance on principle-based standards will place greater responsibility on accountants and auditors to exercise their professional judgement to present a true and fair view of the organisation's performance and financial position (Schipper 2003; Tweedie 2007). The introduction of principle-based standards is not, however, without controversy. Various authors have argued that a lack of rules increases the opportunity for fraudulent and unethical behaviour (for example, Benston, Bromwich, and Wagenhofer 2006; Walker 2007). It is important to consider the social and behavioural influences on the judgement process. To this end, the accountability research of the social psychologist Philip Tetlock (1983) provides important insights.

One important question is whether principle-based standards should be supplemented with indicative rules when it is unlikely that all contingencies can be covered. The concern is that such rules will be seen as a checklist that will lead to justifying the exclusion of a case where the rules do not specifically apply. There is a role for behavioural research, therefore, to inform the standard setting bodies on the implications of this fundamental change to the regulatory regime (Kachelmeier and King 2002; Maines 1994). Therefore, the main objective of this paper is to provide evidence on the effects of supplementary guidance rules in accounting standards. Furthermore, we believe that the effects will be influenced by the level of accounting knowledge.

Lease accounting is used as the context for this research. With the exception of Nelson (2003), there is a dearth of empirical research on the impacts of proposed changes to the current leasing standard on the professional judgement of accountants and auditors. The paper is organised as follows. Section 2 explains the current lease accounting standard and the problems identified with it. Section 3 reviews the prior literature relevant to this paper and develops the hypotheses that were tested in the paper. Section 4 discusses the research method used to test the hypotheses. Section 5 explains the results obtained from the statistical tests undertaken. Finally, section 6 discusses the conclusions, implications and limitations of the paper, as well as suggestions for further research.

Accounting for leases - an illustrative example

The existing international lease accounting standard (IAS 17 Leases) requires that leases are classified as either finance or operating. Leases that transfer substantially all the risks and rewards of ownership of the asset to the lessor are finance leases and all other leases are operating leases. If a lease is classified as a finance lease, lessees must recognise an asset and a liability equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. Whereas, for operating leases, lessees recognise lease payments as an expense and only recognise a liability for any lease payments owing at the end of the accounting period. Indicative rules are provided in IAS 17 for identifying a finance lease, such as if the lessor transfers ownership of the asset to the lessee by the end of the lease term. Many of these rules were introduced to capture transactions that were structured to avoid classification as a finance lease.

In July 2006 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) identified accounting for leases as a priority in the convergence project. The IASB plans to issue an exposure draft of a new lease accounting standard in the second quarter of 2010 and it is envisaged that a final standard will be issued in the second quarter of 2011 (IASB 2009). A discussion paper issued by the IASB in March 2009 identified several criticisms of the existing lease accounting model (IASB 2009). These criticisms include: many users thinking operating leases give rise to assets and liabilities that should be recognised in lessees' financial statements; a reduction in comparability for users from different models for finance and operating leases meaning that similar transactions can be accounted for very differently; and opportunities being provided in the existing standard to structure transactions to achieve a particular lease classification. Therefore, if a lease is classified as an operating lease, the lessee avoids having to recognise any liability associated with the lease other than accrued lease payments. The consequential impact on reported leverage is important in stakeholder negotiations, such as debt covenants.

There is a general assumption that some companies have deliberately structured their leasing agreements to defend an operating lease classification, despite substantial transfer of risk and reward to the lessee. Intentionally choosing accounting methods to mislead investors or hiding the true economics of transactions with the intention of deceiving is argued as being patently unethical (Frecka 2008). Hyatt and Reed (2007, 70) examined a sample of US firms that had to restate their financial statements due to inappropriate lease accounting practices. Interestingly, they find that their sample of restating companies did not have lower quality of financial reporting measures than did their control group of non-restating companies. Therefore, they conclude that the restating companies were not intentionally misapplying the lease accounting standard, but following accounting practices widely used in their industries. Their findings suggest that, at least in some cases, the problems with lease accounting stemmed from a lack of clear direction from regulators, rather than a lack of ethics. This is despite the heavy reliance on rules in the US accounting standards. Consequently, an important question for accounting regulators is whether the additional inclusion of indicative rules can interfere with the application of the underlying principles in accounting standards, particularly when a lease has been structured specifically to circumvent the existing rules.

Literature Review

The problems with lease accounting and the move to a principle-based approach can be viewed within the broader framework of standard setting generally. However, with the exception of Nelson (2003), there is a dearth of empirical research on the impact of this fundamental change in the regulatory framework on the professional judgement of accountants.

One dynamic that needs to be considered is the fact that accountability is an important feature of the decision-making environment for accountants (Gibbins and Newton, 1994; Peecher, 1996). Accountants often face pressure from management to achieve particular financial reporting objectives. This expectation of having to justify one's judgement to an evaluative audience with known preferences (Tetlock 1983) has a significant impact on an individual's judgement process (Johnson and Kaplan 1991; Messier and Quilliam 1992; Simonson and Nye 1992; Peecher 1996). Accountability can have a positive effect on decision performance as it overcomes biases (Simonson & Nye, 1992) and increases attention and effort duration (Cloyd, 1997). However, accountability also leads to deleterious effects, such as conformance and bolstering (Tetlock, et al., 1989). Tan and Kao (1999) found that accountability increased performance in complex tasks, but only when individuals had the requisite knowledge and ability to complete the task.

Two effects of accountability to an audience with known preferences have been identified (see, for example, Quinn and Schlenker 2002). Firstly, cognitive effort can be minimised by simply adopting the evaluator's viewpoint. Secondly, conformance may be seen as a means to maintain personal relationships and avoid conflict. Both effects are likely to be significant in an accounting setting where there is pressure to achieve particular outcomes for the management and or owners of the reporting entity. Both effects result in the consistent finding that individuals tend to conform to the preferences of the evaluator, particularly if it is

difficult to justify resisting such pressure (Tetlock, Skitka, and Boettger 1989; Tetlock and Boettger 1994; Hoffman and Patton 1997; Quinn and Schlenker 2002).

There are obvious implications here for the design of accounting standards. Rather than rules being used as indicative of the underlying principles, as intended by accounting standard setters, they may promote a less cognitively complex, perfunctory assessment that focuses solely on meeting minimum requirements. Furthermore, the lack of a specific applicable rule may make it difficult to resist the pressure to conform to the manager or owner's preferences. This is of great concern since increasingly complex, and perhaps engineered, contractual arrangements make it difficult or impossible to maintain a set of comprehensive rules. We predict that the provision of an incomplete set of rules will increase inappropriate conformance to the owner's preferences, compared with principles-based guidance.

Accountability does not, however, always lead to conformity. Tetlock and Lerner (1999) note that if illegitimacy is perceived people often display belief polarisation - a move away from the position of the evaluator. This is likely to occur if the accountant feels pressure to act against his or her professional judgement and commitment to the profession's ethics. The argument by the standard setters is that, when provided with principle-based standards, accountants will be able to exercise their professional judgement to make decisions that are consistent with the economic substance of the transaction. One of the goals of accounting education is to prepare graduates to exercise the necessary professional judgement and ethics to prepare accounting reports that reflect the economic substance of the transaction. Therefore, we predict that education will lead to appropriate application of accounting principles.

It is not clear, however, whether the accounting education received at university is sufficient to prepare graduates to resist the pressures that they will receive to conform to owner's/ managers' preferences. Again, we believe that it will be particularly difficult to resist such pressure when indicative rules are provided, but are incomplete.

In summary, the hypotheses addressed in this study are as follows:

- H₁ Participants who receive an incomplete set of rules will be more likely to inappropriately classify a lease than will participants who receive a set of principles.
- H₂ The level of accounting education will increase the likelihood that participants will appropriately apply principles in classifying a lease.
- H₃ Supplementing principles with incomplete rules will increase the likelihood of incorrect lease classification, compared to principles only.

Method

Research design

In order to test these hypotheses we performed the following experiment. Specifically, we employed a 2 x 2 between-subjects research design with two forms of standard (principle- or rule-based) and two levels of accounting knowledge (first and second year accounting students). This was followed-up by providing third year accounting students with either principles or principles and rules. The participants, task, independent variables, and dependent variables are as follows:

Participants

One hundred and thirty-two accounting students participated in the experiment. Forty-five were enrolled in the first-year Accounting Principles course, 37 students were enrolled in the second-year Financial Accounting course and 50 students were enrolled in the final year Accounting Theory course. Students were chosen because it allowed greater control over the level of accounting knowledge, an important independent variable. The use of accountant students as surrogates for practising accountants has been investigated in the accounting literature (Liyanarachchi, 2007; Ashton & Kramer, 1980; Abdel-khalik, 1974). A common finding of the research has been that students may be good surrogates for real-world individuals in tasks involving human information processing and certain types of decision making (Ashton and Kramer, 1980, p. 3). Liyanarachchi (2007, p.62) provides a recent review of the literature and concludes that students are adequate surrogates for accountants in decision making tasks.

Task

During their respective accounting lectures participants received a case (see Appendix) in which a partnership is facing the breach of a debt covenant. The loan is to be repaid immediately if the debt-to-equity ratio rises above 0.95:1, which will also result in other creditors calling in their loans thereby bankrupting the partnership. In response, the partners plan to restructure a leasing agreement in order to exclude a major liability, and asset, from the Statement of Financial Position. The case was written to create significant consequences if the owner's preferences are not followed. There are complex ethical issues associated with the decision. This was important in creating a decision that required judgement. The case was considered extensively by the authors and reviewed by other senior academics and consequently we believe that, in substance, the lease should be classified as a finance lease. Of particular note is that the asset is a specialised piece of machinery that is essential in fulfilling the lessee's 10 year contract to clean hydroelectric plants throughout Australia. The partner's stated intention is to renew the lease annually for 10 years.

Participants assumed the role of the accountant responsible for preparing the financial statements and indicated whether they would agree with the partners' wish to exclude the asset and liability from the Statement of Financial Position. Participants were therefore personally responsible for the decision, but the participants were required to justify their decisions to the partners whose preferences were clear.

Participants received two simplified Statements of Financial Position, with and without recognition of the lease liability and asset. The Debt-to-Equity ratio was also calculated for each (58:1 and 1.2:1, respectively).

The effect of accounting knowledge was considered by conducting the task with first year students, prior to any instruction specific to leases and second year students who had been instructed in the nature and classification of operating and finance leases, and final year students at the conclusion of their accounting degree.

Participants received either a discussion of relevant principles from the AASB conceptual framework, or a series of four rules from AASB 117 Leases given as "Examples of situations that individually or in combination would normally lead to future lease payments being recognised as a liability". These rules are the same as those contained in IAS17. The lease was structured to specifically avoid each of the rules provided as can be seen in Table 1.

Table 1.
Indicative Rules and Case Information

Indicative Rule	Case Information Provided to Participants
<i>The lease transfers ownership of the asset to the lessee by the end of the lease term;</i>	<i>"Under the conditions of the lease, GPM has no option to purchase the equipment at the end of the initial 11 month lease term or at any stage during the remaining 9 years."</i>
<i>The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;</i>	<i>"In fact, at the end of the 9 years and 11 months, XYZ plans to sell the equipment to a company in another country for a third of its current value."</i>
<i>The lease term is for the major part of the economic life of the asset even if title is not transferred; and</i>	<i>"The equipment has an expected useful life of 20 years."</i>
<i>At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.</i>	<i>"The fair value of the equipment at this date is \$1,280,125... For the reduced lease term of 11 months, the present value of the minimum lease payments is \$91,667."</i>

In summary, the task was developed to operationalise the following independent variables.

Independent variables:

Type of standard

- Principle-based: The principles as provided in the AASB conceptual framework were provided to the participants.
- Rule based: rules, taken from the AASB117 were provided to the participants.

Knowledge

- 1st year students in an accounting course for accounting majors. The experiment was conducted after a discussion of the nature of assets and liabilities, but before any instruction specific to leases.
- 2nd year students in a financial accounting course who had received instruction relating to the classification of operating and finance leases.
- 3rd (final) year students enrolled in Contemporary Accounting Issues - the capstone accounting theory course for the accounting degree.

Manipulation checks

First and second-year participants indicated whether they had received the relevant accounting principles or rules, and if so the extent (on an 11-point scale) to which they had relied on those principles or rules in making their decision. In the principles-based treatment 97.5 percent indicated that they had received principles and the mean reliance was 6.2436. However, many of the participants in the principle-based treatment (62.5 percent) also indicated that they received and relied (mean =5.6207) on rules. Similarly, participants in the rules-based treatment indicated that they received (90.1 percent) and relied (mean =7.0750) on the rules provided. However, these participants also indicated that they received (83.3 percent) and relied (mean = 7.3289) on principles.

These results suggest that these first and second year participants did not recognise whether they had received principles or rules. It is particularly interesting to note that participants who only received rules believed that they had received and relied on principles in making their decision. The reported reliance on principles by participants that did not receive principles highlights the importance of education in preparing accountants to make this type of judgement. The inability to completely control for the principles that participants might rely on in making their decision will weaken the strength of the manipulation thereby strengthening any confidence in a significant result.

Third-year students who received only principles indicated that they received (95.45 percent) and relied (mean = 7.4762) on principles in making their decision. Only 9.1 percent of these students thought that they had also received rules (compare this with the first and second year students). Third-year students who received principles and rules indicated that they had received (96.4 and 85.7 percent) and relied (mean = 7.3796, mean = 7.0200) on principles and rules, respectively. The relatively greater reported reliance on principles by this group is not significant

The experiment was administered in accounting courses that follow a specified enrolment pattern with prerequisites. Enrolment in the third year course required completion of the second year course, and the second year course required completion of an introductory accounting course. As a manipulation check, participants were asked how many accounting courses they had completed. The results confirm that the extent of accounting education differed significantly between the three groups. ($F=113.184$, $p=0.000$). Accounting experience also significantly differed between years ($F=3.986$, $p=0.021$) but it was relative low in all three (means 0.1444, 1.0583 and 1.3270 respectively).

Participants also indicated on 11-point scales, with 10 being the highest, whether they found the task difficult, felt pressure to comply with the partner's preferred treatment, and took the task seriously. There were no significant differences between treatments for any of these variables. Pressure to conform to the owner's desired treatment was an important check of the accountability that is the basis for our hypotheses. The average response is low to this question was low (3.7115) which decreases the probability of finding a significant result.

Dependent variables

Participants were asked whether they agreed with the partner's preferred treatment to exclude the asset and liability, participants were also indicated on an 11-point scale their confidence in their decision. These measures were combined to determine the strength of the participant's agreement, or disagreement, with the partner's intended treatment of the lease.

Results

H₁ focused on the effect of providing either principles or rules to first and second year students. It was argued that incomplete rules would lead to inappropriate classification, compared with principles.

Table 2
The Effects of Rules versus Principles on Conformance

	Exclude Liability	Include Liability	Total
Principle-based	18 (45.00%)	22 (55.00%)	40
Rules-based	32 (76.19%)	10 (23.81%)	42

Chi-square tests were conducted. The results indicate that participants who received rules were more likely to agree with the partners and exclude the asset and liability from the Statement of Financial Position ($\chi^2=10.581$, $p= 0.001$ two-tailed). The effect of providing principles or rules on the participant's confidence in either supporting or objecting to the partner's preferred treatment was tested with an ANCOVA. The pressure they felt to comply with the partners' preferred accounting treatment (Pressure), and the extent to which they reported taking the task seriously (Serious) were included as covariates.

Table 3
Analysis of Covariance (ANCOVA) Rules or Principles and Decision Confidence

Source	Sum-of Squares	df	Mean-Square	F	P
Pressure	25.969	1	25.969	0.850	0.359
Serious	1.850	1	1.850	0.061	0.806
Principle or Rule	153.551	1	153.551	5.029	0.028
Error	2320.656	76	30.535		

These results also support H₁, participants who received the incomplete rules were more likely to conform to the owners' preferred accounting treatment (mean = 2.7000 versus -0.4125, $F=5.029$, $p=0.028$ two tailed).

H₂ considered the role of education in providing the professional judgement necessary to apply the relevant principles to the case. First, second and third year students who received principles were compared. Interestingly, second year students were more likely to conform to the owner's preferred treatment than either first or third year students. Forty-one percent of first year students, 54 percent of second year students, and 23 percent of third year students conformed and inappropriately classified the lease. Chi-square tests revealed that only third-year students were significantly less likely to conform ($\chi^2=6.545$, $p= 0.011$ two-tailed).

Table 4
The Effects of Education on Conformance

	Exclude Liability	Include Liability	Total
First Year	11 (40.74%)	16 (59.26%)	27
Second Year	7 (53.85%)	6 (46.15)	13
Third Year	5 (22.73%)	17 (77.27%)	22

Tests were also conducted on the second dependent variable that incorporates the level of confidence in their decision. Those participants who received the principles were included in an ANCOVA. Pressure felt to comply with the partners' preferred accounting treatment, and the extent to which they reported taking the task seriously were included as covariates.

Table 5
Analysis of Covariance (ANCOVA) the Effect of Education on Decision Confidence

Source	Sum-of Squares	df	Mean-Square	F	P
Serious	21.161	1	21.161	0.657	0.421
Pressure	0.127	1	0.127	0.004	0.950
Year	175.304	2	87.652	2.720	0.074
Error	1837.113	57	32.230		

The results also support the hypothesis that the level of education influences the application of principles ($F=2.720$, $p=0.074$ two tailed). Although planned contrasts revealed that the difference between first and second year students was not significant ($t=0.744$, $p = 0.230$ one-tailed) the differences between first and third, and second and third year students was significant ($t=1.998$ $p=0.025$ and $t=2.358$ $p=0.011$ one tailed, respectively). Although the difference between first and second year students is not significant, it is interesting to note that conformance (inappropriate classification) actually increased somewhat amongst the second-year students compared with first-year students. This unexpected result was a matter for concern since it seemed to suggest that some education increased the individual's propensity to ignore the underlying economic principles of the transaction and conform to the pressure from owners. One possible explanation is that as students progress through their studies they increasingly see the role of the accountant as one of achieving the owners' interests. The potential for this effect was anticipated and participants had been asked to indicate on separate 8-point scales "When making judgements relating to the preparation of financial statements, to what extent do you believe an accountant should be guided by" : the interests of Owners/ Shareholders; The ethics of the accounting professions; the interests of the community, the interests of government, or the interests of resource providers. There were no significant differences, however, in the reported importance of any particular stakeholder between years.

Finally, an important question is whether principle-based accounting standards should be supplemented with rules-based guidance to illustrate the application of the principles. Consistent with the previous discussion H3 predicted that when incomplete rules are added to principles it will increase the likelihood of inappropriate classification, even for participants with a higher level of education.

Overall, 64 percent of third year students indicated that they would disagree with the partner's preferred treatment. Third year students who received principle-based guidance were more likely to disagree (77%) with the partner's preferred treatment and this is significant ($\chi^2=6.545$, $p=0.011$ two tailed). Only 54 percent of final year accounting students who received the principles AND indicative but incomplete rules rejected the owner's preferences and this difference is not significant to chance ($\chi^2=0.143$, $p=0.705$ two tailed). Therefore, H3 is supported, the inclusion of indicative but incomplete rules increased conformance to an inappropriate accounting treatment.

Conclusions, implications, limitations and directions for further research

Behavioural research has an important role to play in the standard setting process (Maines 1994; Nelson 2003). A particularly important issue affecting current regulatory innovation is the extent to which rules should be specified in accounting standards. The standard for leasing is a case in point and this research provides timely guidance for standard setters seeking feedback on the exposure draft.

Consistent with our hypothesis based on the literature, the results suggest that an incomplete set of rules can lead to inappropriate lease classification compared with the provision of principles. The findings also indicate that, even after three years of university education, supplementing principles with incomplete rules decreased the appropriate classification of the lease. This does not mean that indicative rules should not be provided. The study does not address the benefits that can be derived from guidance rules and thresholds. The results are confined to the circumstance where the rules are incomplete. The findings suggest that indicative rules which address the most common circumstances may prove to be useful and effective in achieving consistent application of the accounting principles. However, the benefits need to be identified through further research and balanced against the risks of providing incomplete rules. In any event, further research may seek to examine the most effective presentation and expression of guidance rules and thresholds.

The use of students in this research does place some limitations on the generalisability of the findings. Given that there was also an interest in the effect of education it was important to have participants with limited education and experience as a base to compare against. The choice of participants provided an opportunity to consider the effects of the specific education received throughout an undergraduate university degree. Since the content of accounting degrees is similar throughout Australia, based on the requirements of the professional bodies, it does provide some justification for making conclusions about the extent to which graduates are prepared to exercise professional judgement based on principle-based accounting standards. The results may not, however be generalised to practising accountants without further research. Of particular interest would be the need to examine the effects of principle or rule-based regulation on financial accountants and auditors, given the differences in the preferences of those to whom they are accountable.

For university educators the results highlight the importance of teaching principles and ethics. Students who had nearly completed their degree were more likely to correctly classify the lease. However, the experimental design did not include a rules only treatment for the final year students, and first and second year students were not provided with the rules and principle-based treatment. Further research would allow these interesting comparisons to be made.

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Appendix

GPM firm is a partnership owned by the three Webster brothers. The business has just been awarded an exclusive 10 year contract to clean the turbines at hydroelectric plants throughout Australia. To satisfy the conditions of the contract, GPM will need to use highly specialised equipment that can not be used for any other purpose. GPM is considering leasing the equipment from XYZ company on a 10 year lease from 1 July 2009. The fair value of the equipment at this date is \$1,280,125 and the present value of the minimum lease payments for this lease term is \$614,460

The partners of GPM are concerned about the partnership's current level of debt. A bank loan was recently obtained to provide finance to expand the business. As part of the contract with the bank, GPM entered into a debt covenant which states that the entire loan will need to be repaid immediately if the debt to equity ratio rises above 0.95:1. If that were to happen, GPM's other creditors would also require immediate payment and the partners would be bankrupt because their personal and partnership assets would be insufficient to pay all of the debts.

In order to avoid bankruptcy, GPM needs to reduce the dollar amount of liabilities recorded on the Statement of Financial Position. One way that the partners could do this is if they were able to exclude from the Statement the asset and liability associated with the equipment it is proposing to lease from XYZ company. The brothers have spoken to the management of XYZ who have agreed to reduce the period of the lease from 10 years to 11 months, with an option for GPM to renew the lease on the same terms (ie year by year) for another 9 years. XYZ's management is confident that the lease will be renewed each year by GPM because XYZ is the only Australian provider of this essential equipment. For the reduced lease term of 11 months, the present value of the minimum lease payments is \$91,667.

Under the conditions of the lease, GPM has no option to purchase the equipment at the end of the initial 11 month lease term or at any stage during the remaining 9 years. In fact, at the end of the 9 years and 11 months, XYZ plans to sell the equipment to a company in another country for a third of its current value. The equipment has an expected useful life of 20 years.

The simplified Statements of Financial Position as at the 1st July 2009 under both lease options are as follows:

Statement of Financial Position (10 year lease term)	Statement of Financial Position (11 month lease term)
Assets	Assets
Current:	Current:
Supplies 320,000	Supplies 320,000
Cash at Bank 55,000	Cash at Bank 55,000
Acc Receivable 400,000	Acc Receivable 400,000
Non Current	Non Current
Motor Vehicles 300,000	Motor Vehicles 300,000
Land and Buildings 500,000	Land and Buildings <u>500,000</u>
Leased Equipment <u>614,460</u>	Total Assets 1,575,000
Total Assets 2,189,460	Liabilities
Liabilities	Accounts Payable 225,000
Accounts Payable 225,000	Bank Loan <u>350,000</u>
Bank Loan 350,000	Total Liabilities 575,000
Lease Liability <u>614,460</u>	Owner's Equity
Total Liabilities 1,189,460	Capital - G Webster 333,333
Owner's Equity	Capital - P Webster 333,333
Capital - G Webster 333,333	Capital - M Webster <u>333,334</u>
Capital - P Webster 333,333	Total Owner's Equity <u>1,000,000</u>
Capital - M Webster <u>333,334</u>	
Total Owner's Equity <u>1,000,000</u>	
Total Liabilities & Owner's Equity 2,189,460	Total Liabilities & Owner's Equity 1,575,000
Debt-to-Equity 1.2:1 (rounded)	Debt-to-Equity 0.58:1 (rounded)

Management have decided to enter into the 11 month lease contract. The question remains, however, whether the future lease payments for the entire 9 years and 11 months should be recorded as a liability on the partnership's Statement of Financial Position as at 1st July 2009. The following accounting principles and rules are available to assist with this decision:

(First and Second year students received principles or rules, third year students received either principles or principles and rules)

Principles from the *Framework for the Preparation and Presentation of Financial Statements (ie AASB Framework)*:

The three characteristics of a liability are:

- Present obligation of an entity;
- Arising from past events; and
- The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations may also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these became apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

Obligations may also be constructive in that they are created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

A liability is recognised in the Statement of Financial Position when:

- It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation; and
- The amount at which the settlement will take place can be reliably measured.

The concept of probability is used in the above recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the liability will flow from the entity.

Rules from *AASB 117 Leases*:

Examples of situations that individually or in combination would normally lead to future lease payments being recognised as a liability are:

-
- *The lease transfers ownership of the asset to the lessee by the end of the lease term;*
 - *The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;*
 - *The lease term is for the major part of the economic life of the asset even if title is not transferred; and*
 - *At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.*
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You are the **accountant** for GPM and are responsible for preparing the partnership's financial statements. The partners of GPM wish to exclude from the Statement of Financial Position the asset and liability associated with the equipment it is proposing to lease from XYZ company.

Do you agree with the partners preferred treatment of the leased equipment?

- Yes (i.e., exclude the asset and liability)
- No (i.e., include the asset and liability)

Name or Student Number: _____

Tutorial day and time: _____

Briefly justify/explain your decision to the partners of GPM: