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PROPOSED ACCOUNTING STANDARD REQUIRES CAPITALIZATION OF ALL LONG-TERM LEASES FOR LESSEES

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ABSTRACT

Accounting for leases has been a controversial issue both internationally and in the United States for a number of years. The focus of the issue has been whether or not simply disclosing the amount of lease commitments by the lessee in the notes to the financial statements is adequate financial reporting for long-term leases classified as operating leases. In 2010 the Financial Accounting Standards Board and International Accounting Standards Board jointly issued an exposure draft, Leases (Topic 840), requiring lessees to report an asset and liability for the present value of the committed lease payments or contracts that extend for more than one year. In July 2011, the two boards agreed to re-expose their proposal for this leases standard. A revised proposal was issued in May 2013. This paper examines changes in several balance sheet and income statement ratios by industry and specifically for a grocery store, a merchandiser, and an airline, that will result from the new accounting standard. As expected, ratios involving liabilities change in a direction making the companies appear more risky. In addition, the income statements are revised by imputing interest on the assumed capitalized amount of noncancellable leases and the interest coverage ratios are recalculated. Two companies reporting profits show a decline in the ratio while the airline actually experiences the ratio changing from negative to positive.

INTRODUCTION

Accounting for leases has been a controversial issue both internationally and in the United States (U.S.) for a number of years. At the heart of the issue is whether or not simply disclosing the amount of lease commitments by the lessee in the notes to the financial statements, particularly those not currently accounted for as capital leases, is adequate financial reporting for long-term leases, or should the amounts be capitalized on the balance sheet as an asset along with an associated liability. In the U.S. current lease accounting falls under Accounting Standards Codification (ASC) 840, Leases. The basis for ASC 840 originated with FAS 13, Accounting for Leases, issued by the Financial Accounting Standards Board (FASB) in 1976. However, as the result of a joint convergence project between the FASB and the International Accounting Standards Board (IASB), in August 2010 the FASB issued an exposure draft, Leases (Topic 840), that changes and simplifies accounting for leases. However, in July 2011, the

Board agreed to re-expose their revised proposals for this leases standard. A new exposure draft was finally released in May 2013.

The proposed standard requires lessees to report an asset and liability for the present value of the committed lease payments or contracts that extend for more than 12 months. Even though most of the issues with lease accounting involve the lessee side of the transaction, for consistency with the FASB-proposed Accounting Standards Update on revenue recognition, this exposure draft deals with lessor accounting as well. This paper, however, focuses solely on the lessee side of the transaction. Accounting for leases is just one of many topics where the FASB and IASB are attempting to harmonize accounting standards so there are fewer differences between countries.

For years much has been written about leases and the need for a change in the accounting rules, particularly in regard to long-term lease commitments that were treated as non-capitalized operating leases and thus escaped liability recognition on the balance sheet. In December 1993 the Association for Investment Management and Research (AIMR 1993) issued a position paper suggesting that lease accounting should require all lease contracts be capitalized as assets and liabilities. In 1996 a publication by an international group of representatives from the FASB and six other national and international accounting standard setting bodies suggested that lease accounting require all lease contracts be capitalized as assets and liabilities (McGregor 1996).

In February 2000, the FASB and other international standard setting bodies jointly published a second Special Report, Leases: Implementation of a New Approach. This document contains detailed proposals incorporating a "new approach" into a proposed lease accounting standard (Nailor and Lennard 2000). A majority of the participants favored an approach where the lessee records an asset and a liability equal to the present value of the committed rental payments and an asset and liability equal to any renewal option, residual value guarantee and/or contingent rent provisions in the lease. A minority of the participants supported an approach where the liability included not only the payments over the lease term, but also the obligation to return the leased asset to the lessor. Subsequently, a discussion of leases from the lessee side of the transaction in the context of the Conceptual Framework and the definitions of assets and liabilities proposed a decision model for choosing between the two alternative interpretations of assets and liabilities (Monson 2001).

Clearly, lease accounting has been an issue for years and discussion of a new standard has been ongoing. After the issuance of the initial exposure draft in 2010, issues remained causing the FASB and IASB to revise the standard. Biondi et al. (2011) presented a perspective of the initial proposed standard on behalf of the American Accounting Association's Financial Accounting Standards Committee. The committee agreed with the right-of-use model in the new standard, but suggested some loopholes still existed that needed to be addressed. These

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loopholes included the scope, special purpose entities and intragroup operations, definition of lease term, discounting, and executor contracts for services. In its re-examination, the FASB and IASB attempted to address these issues. It appears that the FASB and IASB are in the final stages of a new accounting standard that will change the way leases are accounted for and essentially eliminate operating leases with terms of more than 12 months.

In May 2013 the FASB and IASB issued a revised Exposure Draft (ED), Leases (Topic 842) a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840), affecting all public and private companies and not-for-profit organizations that engage in lease transactions (FASB 2013a). The new proposal attempts to provide greater transparency in regard to lease transactions in order to improve the quality and comparability of financial reporting. A majority of leases are not currently reported as liabilities (and assets) on lessee's balance sheets. The new proposal would require recognition of assets and liabilities for leases of more than 12 months (FASB 2013b).

The new exposure draft's "core principle" is that an organization should recognize assets and liabilities that arise from lease obligations greater than 12 months (FASB 2013c). Existing accounting rules on leases often result in long-term lease obligations avoiding liability (and asset) recognition on the statement of financial position. Under the proposed accounting rule, a lease liability and "right-of-use" asset will initially be measured at the present value of lease payments.

A dual expense-recognition approach is required under the new proposal. For equipment, trucks, aircraft and similar assets, interest expense and amortization (i.e., depreciation) will be recognized on the income statement. For property leases, a single "lease cost" will be recognized that will combine the interest expense and amortization expense. These reporting requirements can be avoided by preparers for short-term leases, those that are 12 months or less (FASB 2013c).

The dual expense-recognition approach has already been criticized because it adds complexity for the users of financial statements. In addition, in some cases the line between equipment and property leases is not always clear (Tysiac 2013a). However, the proponents of the new proposal point out that leases are pervasive throughout the U.S. and international economy and due to the variety and complexity of the leases, it was a challenge for the FASB and the IASB to develop a single overriding accounting rule (Tysiac 2013b).

In a lease transaction a lessee acquires the right to control the leased asset, which in effect means the lessee purchases an intangible asset, a "right-of-use" asset. Apparently, to avoid complications related to regulatory issues affecting banks, the FASB did not specifically refer to the right-of-use as an intangible asset, but instead as a leased asset (Lightner et al. 2013).

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OPERATING LEASES BY INDUSTRY

The importance of lease accounting is borne out by the pervasive presence of operating leases across the main industries in the U.S. economy. Exhibit 1 shows the presence of operating leases by industry accompanied by key ratios for firms with and without operating leases for fiscal year 2010.

Note in Exhibit 1 that only one industry, Financial, reports more firms without operating leases than with operating leases. All other industries show that the majority of firms in their respective industries report operating leases. The Retail sector has the highest proportion of firms using operating leases (95%), column (b), and firms using operating leases at the highest levels as a percentage of assets (43.5%), column (c). The Construction sector has the second highest proportion (92%), column (b); however operating leases in that industry make up only 2.7% of assets, column (c).

The Services and Manufacturing industries have the third highest proportions (89%), column (b), and the Services industry reports the second highest level of usage (7.3% of assets), column (c). Wholesale is third at 5.3% followed by Transportation and Agriculture/Forestry/Fish each at 4.0%, column (c).

The median debt-to-assets ratio adjusted to include operating leases as debt, column (f), can be compared to the median of traditional debt-to-assets ratio, column (e). This comparison shows that while some industries' debt-to-assets ratios are only negligibly impacted (The debt-to-assets ratios for Construction, Mining, and Financial all increase by less than 2%), others are impacted to a much greater extent. The retail industry is most impacted. Its debt-to-assets ratio rises from .53 to .67, a 26% increase.

What the industry analysis demonstrates is the pervasive presence of operating leases across industrial sectors and thus the widespread impact of the new proposal. The impact of categorizing operating leases as debt would vary by individual firm, illustrated later.

CURRENT LESSEE ACCOUNTING

In the U.S. current lease accounting falls under Accounting Standards Codification (ASC) 840, Leases, which originated in 1976 from FAS 13, Accounting for Leases. Under current accounting standards leases are classified as either operating or capital. Leases are classified as operating unless they meet one or more of the following criteria, in which case they are treated as a capital lease:

1. The agreement specifies that ownership of the asset transfers to the lessee.
2. The agreement contains a bargain purchase option.

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3. The noncancellable lease term is equal to 75% or more of the expected economic life of the asset.
4. The present value of the "minimum lease payments" is equal to or greater than 90% of the fair value of the asset.

If a lease is considered operating, then the lessee simply records the payments as rent expense. The lessee is also required to report in the notes of the financial statements the amount of noncancellable lease payments by year for the subsequent five years and then a single amount for all the years after. If the agreement is classified as a capital lease, then the lessee records a leased asset and a lease liability. Interest expense is recognized with each payment on the balance of the lease liability and depreciation expense is recorded on the carrying value of the leased asset.

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Exhibit 1

Operating Lease Usage by Industry (2010)

Rows (d) through (k) are medians.

	(a) Number of Firms	(b) Percentage of Firms with Operating Leases	(c) Percentage of Operating Leases to Assets	(d) Debt / Equity	(e) Debt / Assets	(f) Estimated Debt / Assets (with Operating Leases)	(g) Debt / Capital	(h) Interest Cover-age	(i) Return on Sales	(j) Return on Assets	(k) Return on Equity
Agriculture/Forestry/Fish:											
Firms with Operating Leases	25	76%	4.0%	0.68	0.40	0.43	0.22	1.5	2%	2%	3%
Firms with No Operating Leases	8		0.0%	0.59	0.37	0.37	0.37	-10.2	-10%	0%	1%
Construction:											
Firms with Operating Leases	54	92%	2.7%	1.17	0.58	0.60	0.20	0.9	1%	1%	3%
Firms with No Operating Leases	5		0.0%	1.16	0.54	0.54	0.08	1.8	7%	4%	11%
Financial:											
Firms with Operating Leases	617	40%	1.2%	1.78	0.66	0.66	0.25	2.8	7%	1%	7%
Firms with No Operating Leases	937		0.0%	7.75	0.89	0.89	0.32	1.5	10%	1%	5%
Manufacturing:											
Firms with Operating Leases	2337	89%	3.4%	0.64	0.46	0.47	0.08	3.7	3%	3%	7%
Firms with No Operating Leases	296		0.0%	0.31	0.46	0.46	0.00	0.2	2%	0%	11%
Mining:											
Firms with Operating Leases	619	64%	0.7%	0.46	0.33	0.34	0.04	0.3	3%	-2%	-3%
Firms with No Operating Leases	353		0.0%	0.15	0.20	0.20	0.00	-8.5	-6%	-10%	-6%

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	(a) Number of Firms	(b) Percentage of Firms with Operating Leases	(c) Percentage of Operating Leases to Assets	(d) Debt / Equity	(e) Debt / Assets	(f) Estimated Debt / Assets (with Operating Leases)	(g) Debt / Capital	(h) Interest Cover-age	(i) Return on Sales	(j) Return on Assets	(k) Return on Equity
Retail:											
Firms with Operating Leases	323	95%	43.5%	1.00	0.53	0.67	0.19	4.4	2%	4%	11%
Firms with No Operating Leases	18		0.0%	0.83	0.57	0.57	0.14	2.1	5%	5%	14%
Services:											
Firms with Operating Leases	959	89%	7.3%	0.68	0.47	0.51	0.02	3.8	3%	3%	7%
Firms with No Operating Leases	118		0.0%	0.16	0.74	0.74	0.00	-3.5	-24%	-25%	11%
Transportation:											
Firms with Operating Leases	444	56%	4.0%	1.28	0.61	0.62	0.43	2.6	5%	3%	9%
Firms with No Operating Leases	354		0.0%	2.01	0.67	0.67	0.47	2.9	8%	3%	9%
Wholesale:											
Firms with Operating Leases	167	86%	5.3%	1.16	0.56	0.59	0.21	6.2	2%	4%	10%
Firms with No Operating Leases	28		0.0%	0.38	0.54	0.54	0.00	-0.8	1%	0%	6%

The controversy of lease accounting arises from the agreements classified as operating leases, where the contract is long-term and specifies the lease payments as noncancellable. Some argue that these noncancellable contracts meet the definition of a liability and should be reported on the balance sheet. Current accounting standards require that they be disclosed only in the notes to the financial statements. For this reason, some firms structure lease agreements so they qualify as an operating lease and therefore do not have to report the lease liability on the balance sheet, a form of "off-balance sheet financing."

Exhibit 2
Consolidated Balance Sheet
Recent Year-end
Current Lessee Accounting

	Grocery Store	Merchandise Retailer	Airline
Assets			
Current assets	$ 7,450	$11,438	$ 7,741
Property and equipment (net)	13,929	7,709	20,433
Other assets	1,714	5,661	15,365
Total assets	$23,093	$24,808	$43,539
Liabilities			
Current liabilities	$ 7,714	$ 8,786	$ 9,797
Noncurrent liabilities and deferred credits	10,473	6,587	33,497
Total liabilities	$18,187	$15,373	$43,294
Stockholders' Equity			
Common stock and additional paid in capital	$ 4,319	$10,466	$13,827
Accumulated other comprehensive income	(593)	(721)	(3,563)
Retained earnings (deficit)	7,344	4,797	(9,845)
Treasury stock	(6,238)	(5,446)	(174)
Noncontrolling interest	74	339	0
Total stockholders' equity	4,906	9,435	245
Total liabilities and SE	$23,093	$24,808	$43,539
Current ratio (current assets/current liabilities)	0.97	1.30	0.79
Debt/assets ratio (total liabilities/total assets)	0.79	0.62	0.99
Debt/equity ratio (total liabilities/total equity)	3.71	1.63	176.71
Debt/capital ratio (*IBD/(*IBD + total equity))	0.62	0.19	0.99

*Interest bearing debt

Exhibit 2 presents recent year-end consolidated balance sheets of three large U.S. companies: a grocery store, a merchandise retailer, and an airline. We chose a grocery store and a general merchandise retailer because they are pervasive in the economy and commonly report long-term operating leases in their footnotes related to the stores they occupy. An airline was selected because airlines typically hold long-term equipment operating leases on aircraft.

Property and equipment as a percentage of total assets ranges from thirty-one percent for the merchandiser to over sixty percent of the grocer's total assets. One point of interest among the three companies is the nominal amount of stockholders' equity for the airline, where total liabilities are about the same as total assets producing a debt to asset ratio of around 1. A number of U.S. airlines have struggled in the last decade and several have gone through bankruptcy proceedings. A nominal balance, and in some cases a deficit balance, in stockholders' equity in relation to the size of the company is not unusual in the airline industry.

At the bottom of Exhibit 2 are the current ratios, debt-to-assets ratios, debt-to-equity ratios and debt-to-capital ratios for all three companies. The current ratio certainly varies among the three companies with the grocery and airline having values of .97 and .79 respectively and the merchandise retailer having a value of 1.30. The debt-to-assets ratio ranges from .62 for the merchandiser to .99 for the airline. The airline ratio is almost 1.0 since total stockholders' equity is a nominal amount in relation to the size of the company. The debt-to-equity ratio is greater than 1.0 for all three entities, with a particularly large debt-to-equity ratio of 176.71 for the airline due to the high leverage and low stockholders' equity of the firm. The other firms report more reasonable ratios of 3.71 for the grocery store and 1.63 for the merchandiser. Like the debt-to-assets ratio, the debt to capital ratio is almost 1 for the airline, due to the low level of equity. For the merchandiser and grocery store, the debt-to-capital ratios are .19 and .62 respectively, reflecting the grocery store's greater use of long-term debt in its capital structure. Clearly, the balance sheet for all companies will look different under the new accounting standard, where the present value of noncancellable leases will be reported as both an asset and a liability.

In many cases companies structure the leasing of assets, aircraft for airlines and stores for retailers, so the transaction can be reported as an operating lease. Exhibit 3 presents the gross future obligations at year-end of noncancellable operating leases for the three companies. Companies are required to report each of the next five years of noncancellable lease payments individually and then a total for all committed payments after the fifth year. For the airline, the total commitments equal $11,790, which is over half of its reported capitalized property, plant and equipment. For the grocery store, noncancellable leases amount to $6,959 or an amount equal to approximately fifty percent of the reported property, plant and equipment. Finally, the merchandise retailer has $5,514 in total minimum lease payments which is seventy-two percent of the reported property and equipment.

The proposed accounting standard requires capitalizing an amount based on the present value of the noncancellable lease payments. To convert the gross payments to present value the methodology of Damodaran (2009) is applied. The present value of the operating lease commitments is estimated using the reported values from the notes of the financial statements for commitments for the first 5 years and estimated commitments for the periods beyond year 5. To determine the number of periods over which to spread the 'thereafter' portion, we took the thereafter amount of operating leases and divided it by the year 5 commitment amount.[1] We then divided the thereafter portion by the number of years to get the commitment amount used, an amount approximately equal to the commitment in year 5.

Next, we estimated the cost of debt for each firm using the equation:

$$R_D = Rf + DefaultSpread$$

where R_D is a firm's cost of debt, Rf is the risk free rate, proxied by the rate on the 10-year Treasury bond at the time of reporting, and *DefaultSpread* is a risk-based default spread determined by each firm's Standard and Poor's long-term domestic bond rating at the time of reporting.[2] Using this approach resulted in the following costs of debt: 7.76% for the merchandise retailer, 9.10% for the airline, and 5.63% for the grocery store.

Exhibit 3
Noncancellable Future Minimum Lease Payments As of Year-end
Gross and Present Value Amounts (in millions $)

	Grocery Store		**Merchandise Retailer**		**Airline**	
	Gross	PV	Gross	PV	Gross	PV
Year 1	$ 764	$ 723	$ 810	$ 752	$ 1,589	$1,456
Year 2	705	632	736	634	1,407	1,182
Year 3	652	553	636	508	1,296	998
Year 4	600	482	540	401	1,171	827
Year 5	546	415	438	301	1,085	702
Year 6 estimated	525	378	438	280	1,048	622
Year 7 estimated	525	358	438	259	1,048	570
Year 8 estimated	525	339	438	241	1,048	522
Year 9 estimated	525	321	437	223	1,049	479
Year 10 estimated	526	304	437	207	1,049	439
Year 11 estimated			437	192		

[1] The fact that no breakdown of the thereafter portion is reported is a significant shortcoming of the current standard. Without knowing the timing of all of the future cash flows, the present value of commitments cannot be estimated with a high degree of certainty. One method to estimate the commitment beyond year 5 is simply to take the average commitment size over the first 5 years and apply it each year beyond year 5 until the total thereafter amount has been accounted for. For the firms in this study, however, the operating lease commitments declined each year for the first five years (see Exhibit 3), so rather than use the average commitment beyond year 5, we used the lower year five commitment each year until the thereafter portion was accounted for.

[2] Default Spreads were obtained from the website of Aswath Damodaran http://pages.stern.nyu.edu/~adamodar/.

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Total payments	$6,959	$4,505	$5,514	$3,999	$11,790	$7,796

The long-term portion of the right of use asset and lease commitment liability is obtained by discounting back each firm's commitments from year 2 and beyond at its cost of capital. The current portions of these items are estimated separately by discounting back the year 1 commitments separately. Presented in Exhibit 3, these adjustments result in total present value operating commitments of $4,505, $3,999 and $7,796, for the grocery store, merchandiser and airline, respectively.

The proposed accounting standard requires that the liabilities to make lease payments be reported separately from other financial liabilities. In addition, the right-of-use assets are to be reported as if they were tangible assets within property, plant and equipment, but separately from the assets not leased. Since a portion of the committed lease payments is due within the next year, the present values of these amounts are reported separately as current liabilities and their associated current assets.

PROPOSED LESSEE ACCOUNTING

The proposed accounting standard requires the lessee to record a right-of-use asset and a liability to make lease payments. The amount recorded as a liability will be the present value of the committed lease payments. The right-of-use asset will be capitalized at the lease liability amount plus any initial direct costs incurred by the lessee. Subsequently, the lease liability will be reported at amortized cost using the interest method to determine the amount of interest expense and the carrying value of the lease liability. The right-of-use asset is amortized on a systematic basis beginning with the start of the lease. The period of amortization is the term of the lease or the life of the asset, whichever is shorter.

Exhibit 4
Consolidated Balance Sheet
Recent Year-end
Proposed Lessee Accounting

	Grocery Store	Merchandise Retailer	Airline
Assets			
Current assets	$ **8,173**	$**12,190**	$ **9,197**
Property and equipment (net)	13,929	7,709	20,433
Right-of-use leased asset	**3,782**	**3,247**	**6,340**
Other assets	1,714	5,661	15,365
Total assets	$27,598	$28,807	$51,335
Liabilities			
Current liabilities	$ **8,437**	$ **9,538**	**$11,253**
Lease liabilities	**3,782**	**3,247**	**6,340**

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Noncurrent liabilities and deferred credits	10,473	6,587	33,497
Total liabilities	$22,692	$19,509	$51,090
Stockholders' Equity			
Common stock and additional paid in capital	$ 4,319	$10,466	$13,827
Accumulated other comprehensive income	(593)	(721)	(3,563)
Retained earnings (deficit)	7,344	4,797	(9,845)
Treasury stock	(6,238)	(5,446)	(174)
Noncontrolling interest	74	339	
Total stockholders' equity	4,906	9,435	245
Total liabilities and SE	$27,598	$28,807	$51,335
Current ratio (current assets/current liabilities)	0.97	1.28	0.82
Debt/assets ratio (total liabilities/total assets)	0.82	0.67	1.00
Debt/equity ratio (total liabilities/total equity)	4.63	2.05	202.53
Debt/capital ratio (*IBD/(*IBD + total equity))	0.72	0.40	0.99

*Interest bearing debt

Exhibit 4 presents the balance sheet for all three companies with the proposed accounting standard applied. The amount capitalized is the present value of the lease payments calculated in Exhibit 3. The lease payment amount due within one year is classified as a current liability and part of the 'right-of-use' asset expiring within the next year is reported as a current asset.

The current ratio under the new accounting standard rises to 0.82 from 0.79 for the airline, a 3.8% increase. The current ratio for the grocery store was unchanged at 0.97. Finally, the merchandising retailer's current ratio falls from 1.30 to 1.28, a 1.5% decline.

The debt-to-assets ratio deteriorated, i.e., increased, for all three entities since each company originally had a value less than 1. Since the airline's debt-to-assets ratio was almost 1.0 to begin with, the deterioration in the ratio was very minor and does not provide a meaningful comparison. The grocery retailer would experience a 3.8% increase in the debt-to-assets ratio under the new accounting standard and the merchandiser retailer's debt-to-assets ratio would also suffer by 8.1%. The debt-to-equity ratios all deteriorated with the grocery retailer showing a 24.8% increase and the merchandiser retailer showing 25.8%. The airline showed an increase of 14.6% in the ratio.

As with the debt-to-assets ratio, the debt-to-capital ratio for the airline changes very little. However, the debt-to-capital ratios for the merchandiser and the grocery store rise considerably, from .19 to .40 for the merchandiser and .62 to .72 for the grocery store. Beyond the ratio analysis, the added liability is an amount requiring future cash outflows. The right-of-use asset hopefully will provide future cash flows that more than cover the amount of the liability. However, if an airline needs to take a plane out of service or a retailer has to close a store where there is still a long-term lease agreement, the right-of-use may provide little or no value, but the liability must still be paid.

After adjusting the balance sheet numbers and examining the new ratio values, the income statement impact is analyzed. A portion of the rent expense from the operating leases is reclassified and reported as interest expense. Amounts not reclassified to interest expense remain as an operating expense and would be recognized as depreciation expense on the capitalized leased asset instead of rent expense. The reclassification from rent expense to interest and depreciation does not affect the total net income and therefore the impact is not as significant as the balance sheet where total assets and total liabilities are affected.

Following the methodology of Damodaran (2009), the imputed interest on operating leases is estimated by multiplying each firm's cost of debt by its estimated market value (the present value) of operating leases. This imputed interest is added to the reported interest expense to produce the adjusted interest expense. The same amount is subtracted from operating expenses to produce an adjusted operating income.[3]

The new proposal reports separate interest and depreciation for equipment leases and a single "lease cost" for property leases. However, the analysis in this study still maintains the traditional distinction of interest expense separately reported for comparison purposes and because it seems likely that analysts will still calculate interest coverage ratios based on the interest expense contained in the single lease cost amount.

Exhibit 5 presents the income statements for all three companies both before the reclassification of the rent expense to interest expense and after. As evident by each company reporting the same net income before and after the reclassification, there is no effect on the overall income statement. However, the interest coverage ratio used to evaluate a company's ability to make its interest payments has different values applying the proposed accounting standard.

Exhibit 5
Consolidated Income Statement
Recent Year-end Original and Adjusted

	Grocery Store		**Merchandise Retailer**		**Airline**	
	Original	**Adjusted**	**Original**	**Adjusted**	**Original**	**Adjusted**
Income Statement						
Revenues	$76,733	$76,733	$44,043	$44,043	$28,063	$28,063
Operating Expenses	75,642	**75,388**	43,330	**43,020**	28,387	**27,678**

[3] Damodaran notes that this adjustment to operating income is an approximation that assumes that the portion of lease expense that is not interest is equal to the depreciation that would have accrued to the asset is an approximation, but suggests its use since it eliminates the need to estimate depreciation on the right of use asset.

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Operating Income	1,091	**1,345**	713	**1,023**	(324)	**385**
Interest Expense	(502)	**(756)**	(265)	**(575)**	(1,278)	**(1,987)**
Other Income (Exp.)	-	-	(28)	(28)	21	21
EBT	589	589	420	420	(1,581)	(1,581)
Taxes	(532)	(532)	(123)	(123)	344	344
NI	$ 57	$ 57	$ 297	$ 297	$(1,237)	$(1,237)
Interest coverage (operating income/interest expense)	2.17	1.78	2.69	1.78	(0.25)	0.19

Under the current accounting standard, the interest coverage ratios for the grocery store and merchandiser are both greater than 2 with values of 2.17 and 2.69, respectively. The airline has a negative interest coverage ratio (-0.25), resulting from its negative operating income. Like the debt ratios, the coverage ratios will also change as a result of the reclassification of rent expense to interest expense.

The increased interest expense results in lower interest coverage for the grocery store and the merchandiser. Coverage falls from 2.17 to 1.78 for the grocery store and from 2.69 to 1.78 for the merchandiser. Somewhat surprisingly, interest coverage for the airline actually becomes positive, though still very low, 0.19. This occurs because the adjusted operating income becomes positive when rent expense (aproximated as imputed interest) is removed from operating expenses and added to interest expense.

SUMMARY

Lease accounting has been a hotly debated issue for decades. FAS 13, Accounting for Leases (FASB 1976), provided some progress compared to previous attempts to develop lease accounting standards. However, FAS 13 was still considered lacking. “Despite multiple revisions including nine FASB amendments, six FASB Interpretations, 12 FASB Technical Bulletins, and EITF consensuses too numerous to count, there is virtually universal agreement that SFAS No. 13 fails to achieve its stated objectives and needs to be reconsidered” (Monson 2001).

Using financial statements of three companies in different industries, grocery store, merchandise retailer and airline, pro forma income statements and balance sheets are presented for each by applying the proposed lease accounting standard. In addition, several ratios using balance sheet amounts and the interest coverage ratio using the income statement figures were analyzed. As expected, most ratios using liabilities moved in a direction demonstrating a higher risk. The interest coverage ratio declined for the two companies showing a profit and actually improved for the airline that was reporting a loss.

Hopefully, with the cooperation of the FASB and IASB in trying to develop one set of universal accounting standards, the re-exposure draft for Leases (Topic 842) provides a standard that changes and simplifies accounting for leases as well as produce more meaningful and useful information to the users of the financial statements. If the FASB timeline proceeds as planned, the new standard will be issued in the near future.

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