CONVERGENCE OF IFRS AND US GAAP IN THE FIELD OF LEASE: THE IMPACT OF NEW METHODOLOGICAL APPROACHES FOR OPERATING LEASE REPORTING

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Abstract


Since 2002 the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) has begun significantly cooperate in the creation of standards based on the same principals. This is a process of convergence. It is realized through a series of sub-projects aimed at short-term or long-term period. Revenue recognition and lease reporting projects represent priority areas of convergence. The issue of leases belongs to one of the areas in which there have been, after a relatively long time, criticized the very principles applied in international accounting standards. The result of the convergence activities should be the creation of such methodological approaches of reporting the lease contracts on the side of lessee and then lessor that would eliminate the main weaknesses of the current system of reporting based on the classification of lease contracts in connection with the execution or non execution of the transfer of risks and benefits associated with the lease to the lessee. The aim of this paper is to evaluate the impact of implementation of the newly proposed methodological approach for lease reporting in the field of operating leases into the financial statements that will be affected by this change of methodology (balance sheet, income statement). Subsequently, it is evaluated also the impact into selected indicators of financial analysis with a focus on indicators, in whose construction are used items of statements that are significantly affected by the change of the methodological approach.

lease, right of use, lessee, IFRS and US GAAP convergence

Significant national differences in economic, legal and social systems had resulted in different systems of accounting in individual countries. National accounting systems are not currently able to fulfill the function of information source for all external users, as goods, services and capital move across borders in a huge amount. Accounting systems and especially their output – Financial Reporting – should be comprehensible source of information for users from different countries. The way to meet the goal is harmonizing the systems of financial reporting of entities. Currently, the most important financial reporting systems are the International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (US GAAP). Both systems are primarily designed for large accounting entities that are issuers of publicly traded securities. International Financial Reporting Standards (IFRS) are used primarily in the European Union, but also in other countries. Generally Accepted Accounting Principles (US GAAP) have been recently the only reporting system, which was accepted by financial markets in the USA. All companies whose securities were traded in financial markets in the USA were required to transform their statements made in a different system than according to US GAAP to this system. Since this is a highly labor-intensive activity and also expensive,
The financial markets in the USA. From this reason this condition was a highly limiting factor for 346

Accounting Standards Board (FASB) has begun Standards Board (IASB) and the Financial of the 21. century.

global harmonization of reporting in the beginning in strengthening the importance of IAS/IFRS in the result in the loss of confidence in this system and

IFRS approach. There were a number of events that resulted in the loss of confidence in this system and in strengthening the importance of IAS/IFRS in the global harmonization of reporting in the beginning of the 21. century.

Since 2002 the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) has begun significantly cooperate in the creation of standards. On September 2002 in American Norwalk there was published an agreement, based on FASB negotiations, which is recognized by the US Securities and Exchange Commission as the official creator of generally accepted accounting principles in the USA and the IASB, whose ratification initiated the process of convergence of the both systems. In this agreement both organizations have committed to the approach of convergence of accounting standards (IAS / IFRS and US GAAP), so as to be acceptable by the world's capital markets. The agreement follows the decision of the IASB and FASB to include a joint project on the convergence of the two systems in their programs. Document named Memorandum of Understanding, in which the FASB and IASB confirmed their intention from 2002 – to create high-quality global financial reporting standards, was issued in the ongoing convergence process in 2006. This document specifies the areas in which there should be a convergence of approach.

The process of convergence is realized through a series of sub-projects aimed at short-term or long-term period. These are the projects where the unification of accounting rules was expected no later than at the end of 2008. Defined target has not been fulfilled and the convergence is continuing. The completion was expected originally at the end of the year. In June 2011, both Boards agreed unanimously to re-expose their revised proposals for a revenue standard. This was swiftly followed in July 2011 with the announcement that the leases project was also to be re-exposed. Now these two proposed accounting standards are not expected to be published before 2012, so the Boards have tentatively suggested that based on their current timetable, the effective date of the revenue standard not to be earlier than annual periods beginning on or after January 1, 2015. Nothing has been announced about the effective date of the proposed leases accounting standard (Price, 2011).

The online survey, conducted by PWC (2011) in February 2011 among 1,400 respondents (mostly finance executives and professionals), which concerned the importance of the individual areas that are the subject of convergence, clearly shows the convergence of leases as the most important (43% of respondents consider this area as the most important, 31% of respondents consider reporting of revenues as the most important area and financial instruments consider respondents as the third major area).

The issue of leases belongs to one of the areas in which there have been, after a relatively long time, criticized the very principles applied in international accounting standards. The result of the convergence activities should be the creation of such methodological approaches of reporting the lease contracts on the side of lessee and then lessor that would eliminate the main weaknesses of the current system of reporting based on the classification of lease contracts in connection with the execution or non execution of the transfer of risks and benefits associated with the lease to the lessee.

**MATERIAL AND METHODS**

This paper is focused on the convergence of IAS / IFRS and US GAAP. The intention of the IASB and IFRS is to carry out a harmonization of the two systems so that the financial statements drawn up in accordance with the rules of both systems would faithfully show the reality, would be comparable and differences between these systems for purposes of specific financial or capital market would not have to be calculated. A number of sub-projects related to methodological approach for reporting of specific areas of financial reporting are used to meet the objectives of the IASB and FASB. As one of the most important areas is considered to be the area of reporting leases, where the IASB and FASB in addition to ensuring the comparability of the two systems focused in frame of the convergence also on the elimination of the possibility of handling with leasing transactions with an intention to achieve the desired image of the accounting entity, which was subject to serious criticism under the current methodological approach. The aim of this paper is to evaluate the impact of implementation of the newly proposed methodological approach for leases reporting (hereinafter ED lease) in the field of operating leases (replacement of off-balance reporting of leased property by reporting on the basis of transfer of the right to use) into the financial statements that will be affected by this change of methodology (balance sheet, income statement). Subsequently, it is evaluated also the impact into selected indicators of financial analysis with a focus on indicators, in whose construction are used items of statements that are significantly affected by the change of the methodological approach.

Paper could serve as a source of information for external users of financial statements to take a qualified opinion in their assessment of accounting entities which in a greater extent they use property leased in form of operating leases for
its business activity, for the purposes of investment decisions.

At the theoretical level the methodology of processing is based on comparison of approach for identifying, recording and reporting of leases on the side of lessee under the US GAAP and IFRS, with a focus on identifying the most significant differences. Introduced comparison is a prerequisite for the analysis of the published draft of standard relating to leases issued in August 2010, which is the result of joint efforts of the IASB and FASB. The analysis is focused on the proposed changes of the methodologies for reporting leases in comparison with the current methodological approach used in the systems of US GAAP and IFRS on the side of lessee and in particular on their impact on the values of the items of the financial statements. Subsequently the impact of these changes on selected indicators of financial analysis is evaluated.

Effects of methodological approach for reporting lease based on transfer of the right of use on the side of the lessee are analyzed through data of specific entity in which the financing of certain assets under operating leases with a term longer than one year is significant item. Financial position and business performance are presented in form of simplified financial statements (balance sheets and income statement). The aim is to quantify the impact of the proposed methodological approach for reporting operating leases. Quantification is performed by comparing the values of selected indicators of financial analysis using existing methods for recording and reporting of operating leases and newly proposed approach. Evaluated entity uses standard contracts on operating leases, i.e., that the contract is concluded for a specified period, clearly, does not contain an option to extension of the lease or purchase of the asset, does not include contingent rent and is not a lease of a specialized nature asset 1.

To quantify the impact of changes of the methodological approach there are selected indicators of financial analysis based on the balance sheet (balance and profit and loss statement (income statement), whose construction is based on the items affected by the change of methodological approach for reporting leases. This is the value of assets, the value of liabilities and the value of selected items of costs.

It is evaluated the impact of new methodological approach both to values of absolute indicators (horizontal analysis – how in absolute and relative amount changed certain item of a financial statement, vertical analysis – the proportion of the individual components of the balance sheet on the total balance sum) and to the values of ratio indicators (profitability ratio, liquidity ratio, indebtedness ratio.

- Return on assets – ROA = Net income / total assets
- Return on equity – ROE = Net income / shareholder's equity
- Debt ratio – total indebtedness [total debt / total assets] × 100
- Liquidity ratios.

Theoretical background

Lease currently represents an important way of financing long-term assets. Deloitte (2009), based on global annual lease states that assets worth 760 billion USD are funded worldwide in form of operating or financial leases. In Europe, in 2010 leases contracts or contract to purchase a property in installment payments were concluded (through companies that are members of the Leaseurope association, which is the vast majority) that worth approximately 280 billion USD contracts worth 843 billion USD have been carried out already. From these contracts 86% were represented by contracts that have been identified as lease and 14% of the contract for the purchase of property in installment payments. Economically both lease and purchase of assets in installment payments represent similar transaction, but in frame of financial reporting in many systems there is a totally different reporting of these transactions, which can greatly affect the economic decisions of users of the financial statements.

In a number of national financial reporting systems (national GAAP) is reporting of leases contracts treated according to the concept of legal ownership and therefore economic substance of transactions is not respected. This means that the object of the lease is reported in the assets by the legal owner, not the body that economic benefits from the leased asset will flow to. Regardless to the classification of the leases (e.g. contractual division to the operational or financial leasing) so during the lease term is object of the lease reported in the assets of lessor, who also depreciates it as the owner, even though the control of the asset and access to economic benefits (economic ownership) has a lessee. Exceptions are e.g. Croatia, Cyprus and Malta, which use the full IFRS for most entities (they are not limited only to issuers of securities traded on registered markets using the concept of economic benefits, i.e. the possibility of reporting assets that are object of the lease to include into assets of the lessee. French rules allows in limited way (on a voluntary basis) to include assets from financial lease into the assets of lessee, but this possibility according to Ernst & Young and the Ministry of

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1 As results from CL to ED available on http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/ed10/Pages/Ed.aspx for above defined cases there are discussed variant approaches to their recording, impact of application of these approaches into the indicators of financial analysis is significantly different that lead Councils to release of re-exposure draft (end of 2012).
Finance (2005) uses only few entities. In some systems, such as in Germany, there is possible to use capitalization of leases on the side of lessee only in specific cases – for example the land lease, which will be in the near future purchased by the lessee (Vaněk, 2003). The issue of leases for entities that are issuers of securities traded on the capital markets is regulated under full IFRS by standard IAS 17 – Leases.

Lease is classified in this standard as an agreement whereby the lessor provides to the lessee the right to use an asset for a specified period for a one payment or series of payments over a specified period. Lease is classified as financial if it transfers substantially all risks and rewards incidental to ownership of an asset to the lessee. For classification of lease as a financial lease is irrelevant whether after the end of the lease there will be transfer of ownership to the lessee. Otherwise we are speaking about operating lease.

Lease relation in the case of a financial lease is similar to the acquisition of the relevant asset through the loans, and from this consequently results the way of its reporting in accordance with IAS 17.

At the moment of commencement of the lease the object of the lease is recognized in the assets and liabilities of the lessee at the lower amount from the fair value of leased asset and the present value of the minimum lease payments. Consequently, at the time of payment of lease installment payments, each payment is always divided into the following parts – the amortization of the liability from the lease and interest (financial costs accounted into the income statement). Financial costs are allocated into each period during the lease term so as to achieve a constant interest rate for the remaining balance of the liability. The amount of interest is in each period determined as multiple of the effective interest rate, which is constant throughout the lease term and the actual amount of remaining outstanding liability. The sum of the interest over the lease term decreases, vice versa in each period increases the amount decreasing the liability from lease. Leased asset is depreciated according to the depreciation plan by lessee, consistently with its other depreciation of fixed assets – thus while respecting the standards IAS 16 – Property, plant and equipment or 38 – Intangible Assets. In case that the lessee is not sure that after the end of the lease term the object of lease will be transferred to the lessee, the object of the lease should be fully depreciated over the lease term, otherwise the asset should be depreciated over its entire lifetime. The entity should also respect impairments of assets in the balance sheet.

There is Topic 840 – Leases related to reporting lease after the US GAAP codification. It includes mainly SFAS 13, SFAS 17, SFAS 23, SFAS 26 and SFAS 145. Even though the current IAS (IFRS) and US GAAP approach to reporting leases is in similar way (the same principles are applied), there may arise situations in which the same lease contract can be classified differently in the introduced reporting systems, which will lead to different reporting in the financial statements. This fact arises from the fact that US GAAP may be based on similar criteria for the classification of a lease as a financial (capital) as it is in the case of IFRS, so from a transfer of ownership of property to the lessee, the profitability of the future purchase, relation of period of the lease in relation to the economic lifetime of the asset or ratio of the present value of the minimum lease payments in relation to the fair value of the leased assets – however unlike IFRS, according to US GAAP reporting entity cannot determine the limit values by itself. The reporting unit must respect the values defined by standards setter – for classification of lease as a financial lease the ratio of the present value of the minimum lease payments must be equal or exceed 90% of the fair value of the leased property. For a substantial part is considered 75% of the lifetime of the leased asset. US GAAP also do not contain provisions setting out the obligation of classification of lease as a financial lease for lease of specific devices which may be used without major modifications only by lessee.

IAS 17 also includes initial direct costs of the lessee into the evaluation of the leased asset. For classification of lease as a capital lease under US GAAP it is sufficient the fulfillment of any (and only one) of the conditions by the lessee, which are:

- the transfer of ownership to the lessee by the end of the lease term,
- the lessee has the option of good purchase (selling price is lower than the expected fair value)
- the lease term is for the major part of the economic life,
- present value of minimum lease payments exceeds introduced 90% of the fair value.

Otherwise, it is evaluated as an operating lease.

Present value of minimum lease payments under US GAAP is calculated using the lower of the implicit interest rate on the side of lessor and the lessee’s

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2 Payments over the lease period that lessee committed to pay (with exception of contingent rent) increased by other amounts on the side of lessee which lessee or the side connected to lessee has committed to pay. Implicit interest rate, if it is possible to determine it, is used as discount rate for discounting of payments. This interest rate is internal rate of return on the side of lessor. Introduced rate corresponds to a rate for which applies that gross investment into the lease (sum of the minimum lease payments and unguaranteed residual value) is equal to sum of the fair value of the leased asset and initial direct costs of lessor. It is not possible to determine it in some cases. In this case a standard allows to use incremental (so marginal) borrowing rate of lessee.

3 The rule does not apply if the start of the lease is in the period of 25% of the total expected lifetime, including years, when the property was used.
incremental borrowing rate. IAS requires always use the implicit interest rate, if this information is known. The methodology used to determine the incremental borrowing rate of the lessee could be considered as a difference. While IAS prefers its determination as the interest rate which would the lessee have to pay when using comparable lease, only if that is not determinable, it is possible to use the interest rate that would have to pay if he would borrow funds on the comparable period. Such method of determining the incremental interest rate is standard under US GAAP.

The example of leases shows a substantial difference between the reporting systems based on principles that include IAS/IFRS and systems based on rules (US GAAP). It is obvious that the rules-based system requires a much greater level of regulation detail, which is evident in the number of regulations relating to this issue in the relevant standards. On the other hand, it is clear that US GAAP require for classification of lease as a capital lease keeping the fixed boundaries, give to the reporting entity possibility to easily structure leases contracts so as to avoid the reporting in the balance, which may be regarded as disadvantages of the system based on rules. Neither Nobes (2005) does not believe, unlike the proponents of the system based on the rules that the absence of clear rules will lead to inaccuracies, lack of verifiability or spatial inconsistency. As sufficient for correct classification he considers the clear definition of criteria for the assets and liabilities recognition.

The main differences between the approach of IFRS and US GAAP to leases on the side of lessee are given in Tab. I.

### RESULTS AND DISCUSSION

The current approach to reporting leases is subjected to sharp criticism from many economists and users of financial statements (Joanne Duke, ...
The economic substance of the similar contracts can be evaluated in a number of cases differently by reporting entity – as operating or financial lease with a completely different impact on the financial statements. This inconsistent approach, which is not clearly in contradiction with the methodological approach for reporting, may also be motivated by the intention of misrepresent the financial position of the reporting entity, depending on whether the reporting entity wants assets and liabilities and relative indicators of financial analysis to overestimate or underestimate. The motive may be such an effort to hide liabilities from creditors or owners or affect the economic income in the desired direction. Results of the survey of Joanne Duke, Hsieh, and Su (2009) showed that even in the post-Enron period, there have been many companies that use reporting leases as operating to hide their liabilities and assets from its investors and at the same time to achieve a more favorable net profit, respectively, retained earnings from the previous years. The authors also point out that by reporting the lease as an operating instead as a financial may also significantly improve indicators of financial analysis, such as the Debt/Equity ratio, current liquidity indicators, ROA indicator and others. According to estimation of these authors unrecorded lease liabilities (URLs – unrecorded lease Liabilities) make up 11.13% of the reported liabilities, unrecorded lease assets (URA – unrecorded lease assets) account for up to 3.97% of their total assets. Rightfully there is a question, whether the formation of contract on operational lease does not arise the need for a lessee to report identifiable asset and especially unconditional liabilities in the balance sheet. The actual description of lease contracts in the annex to financial statements cannot be considered in this sense as providing sufficient information for users of financial statements for their economic decisions.

Proposal to include the leased asset into the assets of lessee (capitalization) of at least part of leasing contracts designated as operating leases can be observed even by the G4 +1 group (Lipe, 2001), which requires the capitalization into liabilities of all irrevocable lease contracts with a minimum duration of one year. This proposal was considered to be quite controversial and unleashed a rather extensive discussion. McGregor (1996), Nailor and Lennard (2000) and others have dealt with the possible impacts of capitalization on the statements of the reporting entities. Cited authors are in favor of capitalization of major part of leases contracts classified as operating leases. The results of the studies analyzing the impact of capitalization of operating lease on the side of lessee (Houlihan and Sondhi (1984)), Imhoff, Lipe, and Wright (1993), Sannella (1989), Beattie, Edwards, Goodacre (1998)), Bennett and Bradbury (2003), Durocher (2005)), however significantly differed, which was caused by the methodological approach used for recording capitalization6.

On the other hand, one can also meet with the opinions against the capitalization of mentioned lease contracts, since users and also reporting accounting entity in the opinion of following authors (Beattie, Goodacre, and Thomson (2006), Finnerty, Fitzsimmons, and Oliver (1980), Ely (1995) and Beattie, Goodacre, and Thomson (2000), Wilkins (1984), Wilkins and Zimmer (1997)) are taking into account the absence of a displaying the operational lease in the balance sheet of lessee in their financial decisions and they count with it as part of their risk management. By contrast, other studies disagree and consider information about the liabilities to be very important especially for providers of foreign sources, who require the capitalization of the vast majority of lease contracts.

Based on the number of inconsistence associated with the application of the existing rules for the reporting of leases under schemes IFRS and U.S. GAAP IASB and FASB they have begun to work since 2006 on a joint project with the aim to create a standard based on principles for reporting lease that would truly show the essence of the lease transaction. In March 2009 IASB and FASB published a discussion paper Leases – Preliminary Views and they invited professionals to take a stand to this material. Based on the response from the professionals it was created a draft of standard, which was published in the form of Exposure Draft (ED) in August 2010. Approximately 770 respondents mainly from practice, but also from academia, and from more than thirty countries worldwide expressed themselves in the public debate on the draft. Respondents were the lessees and lessors operating in different sectors, auditors, legislators and representatives of large multinational companies. ED is based on the assumption that it is economically correct that also operational leases would be recorded in the lessee's balance sheet (with certain exceptions). Therefore unification of methodological approach for the reporting of leased assets regardless of the form of lease (operational

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5 The G4+1 comprises members of national standard-setting bodies from Australia, Canada, New Zealand, the United Kingdom, and the United States of America.

6 SP methods, factor method and Fitch model are the most often applied method of capitalization.
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...and financial) represents a major change from the current rules, which is designed in the ED for reporting on the side of lessee. This approach eliminates the need for classifying leases according to defined criteria. The only proposed exception is the short-term leases, for short-term criterion is considered to be the limit of one year. Permit of exceptions from the established concept is always associated to a risk of handling with transactions in order to achieve the intended impact on financial reporting.

The unification of approach in ED is based on the principle of the transfer of rights to use under which at the time of initiation of the lease the asset is recognized (the right to use the property) and liability (duty to pay rent) for the lease term. The fair value model or a model based on cash flows for their initial measurement can be generally used. Boards inclined to the application of model based on cash flows, mainly because of easier application (it is not required regular updating of fair value). The proposed model is linked to the need to determine the appropriate interest rate for discounting the expected lease payments. It is possible likewise in the case of the model used so far for the reporting of financial lease – a model of total assets to use the implicit interest rate (which is associated with the risk of its difficult finding by lessee) or incremental interest rate7. The asset is then depreciated, either for a shorter period of the lease term and economic life. Commitment, initially reported at the present value of the lease payments is subsequently decreased simultaneously with the performed payments, and relevant interest is included in the costs of lessee.

Application on the standard lease contracts is relatively straightforward, considerable problems may arise especially in the case of contracts containing specific provisions, such as:

- contracts with options to continue the lease for a secondary period or purchase of the leased item,
- contracts concluded for an indefinite period,
- contracts containing a significant component of contingent rent,
- assets leased in parts (housing units or offices), etc.

Effects of methodological approach for reporting lease based on transfer of rights to use of the lessee are analyzed through data of specific entity in which the financing by part of assets through operating lease with a term longer than one year is a significant item. Financial position and business performance is presented in form of simplified financial statements (balance sheets and income statement). The aim is to quantify the impact of the proposed methodological approach for reporting of operating leases. Quantification is performed by comparing the values of selected indicators of financial analysis using existing methods for recording and reporting of operating leases and recently proposed approach. Evaluated entity uses standard contracts on operating leases, i.e., that the contract is concluded for a specified period, clearly, does not contain an option to prolong the lease or purchase of the leased asset, does not include conditioned lease and it is not a lease of a unique object.

Entity hired five cars in form of operating leases, which the lessor acquired for the amount of 338 480 CZK per piece (price is without VAT, in the analysis there is abstracted from VAT, as this item will not affect significantly the indicators that are their subject). Lessor’s implicit interest rate is 7.2024%. Lessee pays 103 750 CZK quarterly, plus a lump sum of insurance and maintenance is paid 2 400 CZK. The lease period is 2 years. In order to ensure comparability the data were modified as the contracts were commenced in the beginning of this year.

II: Selected characteristics of leasing contracts - values are given for all five hired cars

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Liability reduction</th>
<th>Interest</th>
<th>Interest per year</th>
<th>Liability</th>
<th>Amortization of right to use</th>
<th>Right to use netto</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 1.</td>
<td>Year</td>
<td>103 750</td>
<td>90 277</td>
<td>13 473</td>
<td>0</td>
<td>678 144</td>
<td>768 144</td>
</tr>
<tr>
<td>31. 3.</td>
<td>Year</td>
<td>103 750</td>
<td>91 861</td>
<td>11 899</td>
<td>0</td>
<td>586 006</td>
<td></td>
</tr>
<tr>
<td>30. 6.</td>
<td>Year</td>
<td>103 750</td>
<td>93 472</td>
<td>10 278</td>
<td>0</td>
<td>492 534</td>
<td></td>
</tr>
<tr>
<td>30. 9.</td>
<td>Year</td>
<td>103 750</td>
<td>95 111</td>
<td>8 639</td>
<td>44 279</td>
<td>397 422</td>
<td>384 072</td>
</tr>
<tr>
<td>31. 12.</td>
<td>Year</td>
<td>103 750</td>
<td>96 780</td>
<td>6 970</td>
<td>0</td>
<td>300 643</td>
<td></td>
</tr>
<tr>
<td>31. 3.</td>
<td>Year</td>
<td>103 750</td>
<td>98 477</td>
<td>5 273</td>
<td>0</td>
<td>202 166</td>
<td></td>
</tr>
<tr>
<td>30. 6.</td>
<td>Year</td>
<td>103 750</td>
<td>100 204</td>
<td>3 546</td>
<td>0</td>
<td>101 962</td>
<td></td>
</tr>
<tr>
<td>31. 12.</td>
<td>Year</td>
<td>103 750</td>
<td>101 962</td>
<td>1 788</td>
<td>17 577</td>
<td>0</td>
<td>384 072</td>
</tr>
</tbody>
</table>

Source: authors’ own work

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7 the rate would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term and security attached to the underlying asset during and at the end of the lease term
Tab. II shows description of lease contract under the new methodological approach to operating leases with lease term longer than one year. Under this approach the entity recognizes the liability to pay rent at the time of commencement of the lease term. The liability is recognized at the discounted value of the minimum lease payments when implicit or incremental interest rates is used. The entity also acquired the right to use that property for the lease term. These assets are recognized as a long-term assets in the form of a right of use. In accordance with the Leases ED the assets are measured at the same value as the liabilities. During the lease term is an obligation amortized using the above mentioned rate, the right of use is subject to straight-line depreciation.

A comparison of balance sheets for the lease term using current approach to operation lease reporting and the ED lease approach is the object of the Tab. III. In comparison with the current methodological approach to operating lease reporting with longer than one year term there is an increase of entity’s total assets under the ED lease approach. There were not affected total assets in the moment of lease commencement under the current approach. When comparing the total assets for lease term the most significant difference arises at the time of the lease commencement. Due to reduction of obligation and rights of use amortization these differences diminish during the lease term and at the end of lease term are equal zero.

As can be seen from the comparison of income statements prepared under analyzed methodical approaches to reporting the course of costs over time vary considerably. While under the current approach the cost associated with operating lease are reported on straight-line basis, using the ED lease approach the costs associated with lease are divided into two groups of costs, depreciation costs in the form of right use amortization and financial

### III: The comparative balance sheets of application both lease reporting methodological approaches

<table>
<thead>
<tr>
<th>Item</th>
<th>1. 1. 1. y.</th>
<th>31. 12. 1. y.</th>
<th>31. 12. 2. y.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>26,926</td>
<td>36,653</td>
<td>56,178</td>
</tr>
<tr>
<td>Fixed assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intangible fixed assets</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tangible fixed assets</td>
<td>5,023</td>
<td>6,349</td>
<td>6,521</td>
</tr>
<tr>
<td>Long-term financial assets</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Current assets:</td>
<td>21,534</td>
<td>39,542</td>
<td>41,187</td>
</tr>
<tr>
<td>Inventory</td>
<td>539</td>
<td>798</td>
<td>798</td>
</tr>
<tr>
<td>Long-term receivables</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Short-term receivables</td>
<td>17,902</td>
<td>15,131</td>
<td>32,044</td>
</tr>
<tr>
<td>Short-term financial assets:</td>
<td>3,093</td>
<td>14,079</td>
<td>17,277</td>
</tr>
<tr>
<td>Cash</td>
<td>517</td>
<td>83</td>
<td>2,126</td>
</tr>
<tr>
<td>Bank accounts</td>
<td>2,576</td>
<td>13,530</td>
<td>14,219</td>
</tr>
<tr>
<td>Accruals</td>
<td>369</td>
<td>762</td>
<td>470</td>
</tr>
<tr>
<td>TOTAL LIABILITIES AND EQUITY</td>
<td>26,926</td>
<td>36,653</td>
<td>56,178</td>
</tr>
<tr>
<td>Equity:</td>
<td>13,888</td>
<td>17,704</td>
<td>25,044</td>
</tr>
<tr>
<td>Registered capital</td>
<td>960</td>
<td>960</td>
<td>960</td>
</tr>
<tr>
<td>Reserve funds, statutory reserve account for</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>cooperatives and other retained earnings</td>
<td>960</td>
<td>960</td>
<td>960</td>
</tr>
<tr>
<td>Profit/loss previous year</td>
<td>9,580</td>
<td>12,736</td>
<td>17,435</td>
</tr>
<tr>
<td>Profit/loss current year</td>
<td>3,156</td>
<td>3,816</td>
<td>6,457</td>
</tr>
<tr>
<td>Other sources:</td>
<td>12,939</td>
<td>18,949</td>
<td>31,134</td>
</tr>
<tr>
<td>Provisions</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Long-term payables</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Short-term payables</td>
<td>12,939</td>
<td>17,238</td>
<td>27,365</td>
</tr>
<tr>
<td>Estimated payables</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Bank loans and fi n.accomodations</td>
<td>0</td>
<td>1,711</td>
<td>3,769</td>
</tr>
<tr>
<td>Accruals</td>
<td>99</td>
<td>99</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: authors’ own calculation based on real financial statements

8 CA = current approach, ND = new draft
costs in the form of interest costs. While the right to use is usually depreciated on straight-line basis, the financial (interest) costs have decreasing trend in the lease term. This leads to a shift of costs in the initial stages of lease. This shift is greater the longer the lease term, which also proved Svoboda (2011). Shifting of a part of the costs which were previously reported on straight-line basis in the early stages of lease term results in deviating reporting of costs from the cash flows of an entity. Users of financial statements need not perceive it in a quite positive way, as it decreases profitability.

Due to the application of ED Lease approach there are changes in the structure of assets, the amount of change is proportional to the value of assets leased under operating leases. The proportion of long-term assets (either tangible or intangible assets in connection with the final decision of the IASB and FASB) increases significantly. The most significant change is in the early stages of the lease. This proportion decreases in time due to the amortization (depreciation) of the right to use. The structure is not affected at the time of termination of the lease contract at all. There is also a change in the structure of liabilities and equity. The share of
equity in total liabilities and equity decreases due to reporting the obligations arising from operating lease at the commencement. The lease liability splits on two parts – the short-term (due within one year) – and the long-term part as a result of the correct application of the rules IAS1 – Presentation of financial statements. By splitting liability on these
two parts are affected as debt ratios, as well as all liquidity ratios.

Tab. VI. demonstrates that there is a change in the cost structure due to ED Lease approach. The expense are not presented by lease payment any more. With operating leases are associated two types of costs – amortization (depreciation) of the right to use and financial expense in the form of interest on the unpaid obligation. It means that the share of financial costs associated with operating lease decreases in time in the course of the lease term – see Tab. IV (compared to the recognition of interest costs using the CA and ND). This fact is not clear from the Tab. VI. The cost structure is not affected only by varying methodological approaches for the operating lease reporting but by number of other economic transactions of the entity in the reporting periods as well. Declining share of interest cost in time is unclear. The Tab. III shows the increase in bank loans and an increase in financial costs in the form of interest in the analyzed period.

Due to reporting of rights to use as an asset and the obligation to pay rent as a liability there are the profitability of total assets and return on equity reduced compared to the current approach of reporting. As shown in the Tab. VII, there is observable growth of these ratios in the course of the lease term compared to current approach. This increase is higher in case of ROE. There is decrease of the current ratio in the early stages of the lease. It is due to the inclusion of the part of lease liability (due within 12 months) to current liabilities under the ED lease approach.

CONCLUSION

The paper shows that new methodology for lease reporting on the side of lessee may influence indicators of the financial position and performance of companies that are used for external users for their financial decision making. This especially concerns those entities with high volume of assets acquired under lease evaluated as operational lease under current principles. The impact obviously depends on details of specific methodological approaches, such as determining the length of the lease, methods of reviewing estimates, treatment of contingent rentals, etc.

Some of these changes can be evaluated positively (for example true and fair view of lease obligation and the right to use property), but some may have negative impacts on the reporting entity (for example in case of applying for loans or grants). There is a significant change in the cost structure under a new approach. At the current methodological approach of lease reporting the operating costs are recognized on straight line basis while at new approach are costs decreasing during the lease period due to straight line depreciation of the right to use and interest (decreasing in time). There is a conflict in relation between the total costs of cash flows in comparison to current approach. The cost structure is different as a consequence of these changes, value of all parameters that work with EBIT (Earnings before Interests and taxes) and EBITDA (Earnings before Interests, Taxes, Depreciation and Amortization) is different as well.

The actual value of these indicators as a result of recognition of interest and the right to use depreciation improves (increases). In contrast, EAT (earning after taxes) indicator does not show upward trend over the lease term. With regard to profitability indicators, there is usually a decrease in ROA (return on assets) indicator, which decreases despite the increase in EBIT. Increase in EBIT is not as high as increase in fixed assets which would not be recognized at all under current approach.

This indicator increases in case of a usual lease term. ROE indicator compares the overall performance of the equity to the total return of capital. Given the decline the value of this indicator the value of this indicator may increase due to

<table>
<thead>
<tr>
<th>Table VII: Selected Financial Analysis Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>ROA</td>
</tr>
<tr>
<td>Current Ratio</td>
</tr>
</tbody>
</table>

Source: authors’ own calculation based on real financial statements

<table>
<thead>
<tr>
<th>Table VIII: Expected impact of applying the new concept to the values of selected financial ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>ROA</td>
</tr>
<tr>
<td>Total assets turnover</td>
</tr>
<tr>
<td>Current ratio</td>
</tr>
<tr>
<td>Debt equity</td>
</tr>
<tr>
<td>Interest coverage</td>
</tr>
</tbody>
</table>

Source: authors’ own research
increase in liabilities. As regards the impact on liquidity indicators, there is a decline in indicators of current ratio and quick ratio due to increase in payables as a result of which a portion will undoubtedly pose a short-term payable. On the other hand, may not be so dramatic decrease in cash flow, liquidity indicators, because although there is an increase in the liabilities, but also the indicators of cash flow from operating activities are improved.

Regarding debt ratios and financial stability, debt increases in case of short term and long term. In comparison to current approach when existing contracts are reported as operating lease it led to recognition neither contract liability nor any asset connected with lease. In addition to short respectively long-term liabilities recognition there is a long-term asset recognized. The value of the liability is reduced usually slower than an asset. It results in an increase in debt. Debt to equity ratio also increases. Influence of selected ratios of the new methodology of the other lease summarizes the following table.

**SUMMARY**

The aim of this paper is to evaluate the impact of implementation of the newly proposed methodological approach for lease reporting in the field of operating leases into the financial statements that will be affected by this change of methodology (balance sheet, income statement). Unification of methodological approach for the reporting of leased assets regardless of the form of lease (operational and financial) represents a major change from the current rules, which is designed in the ED for reporting on the side of lessee. This approach eliminates the need for classifying leases according to defined criteria. The only proposed exception is the short-term leases, for short-term criterion is considered to be the limit of one year. Permit of exceptions from the established concept is always associated to a risk of handling with transactions in order to achieve the intended impact on financial reporting.

There is evaluated the impact into selected indicators of financial analysis with a focus on indicators, in whose construction are used items of statements that are significantly affected by the change of the methodological approach in the paper. Effects of methodological approach for reporting lease based on put transfer of rights to use of the lessee are analyzed through data of specific entity in which the financing by part of assets through operating lease with a term longer than one year is a significant item. The results of analyses show that the new methodology for lease reporting may influence indicators of the financial position and performance of companies that are used for external users for their financial decision making.

Some of changes could be considered as positive (for example true and fair view of lease obligation and the right to use property), but some of them may have negative impacts on the reporting entity financial position and level of performance (for example in case of applying for loans or grants). There is a significant change in the cost structure under a new approach. At the current methodological approach of lease reporting the operating costs are recognized on straight line basis while at new approach are costs decreasing during the lease period due to straight line depreciation of the right to use and interest (decreasing in time). There is a conflict in relation between the total costs of cash flows in comparison to current approach. The cost structure is different as a consequence of these changes, value of all parameters that work with EBIT (Earnings before Interests and taxes) and EBITDA (Earnings before Interests, Taxes, Depreciation and Amortization) is different as well.

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