ACTA UNIVERSITATIS AGRICULTURAE ET SILVICULTURAE MENDELIANAE BRUNENSIS

Volume LX 37 Number 7, 2012

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

P. Svoboda, H. Bohušová

Received: September 4, 2012

Abstract

SVOBODA, P., BOHUŠOVÁ, H.: *Convergence of IFRS and US GAAP in the field of lease: the impact of new methodological approaches for operating lease reporting.* Acta univ. agric. et silvic. Mendel. Brun., 2012, LX, No. 7, pp. 345–358

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, this condition was a highly limiting factor for non-US companies in trading with their securities in the financial markets in the USA. From this reason Mládek (1998) had earlier considered them as the best candidate for a system that would represent a global system of financial reporting US GAAP, which is rigorous and is a goal to which should IAS / 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 (Brice, 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 intension 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

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[2]. 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[3].

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

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. [4]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,

I: *The main differences between recognized financial reporting systems in the fields of leases*

Field	IFRS approach	US GAAP approach
Classification criteria	Limit values for classification lease as a finance are not determined	Minimum ratio of the minimum lease payments to the fair value and the minimum leased period to the lifetime
Methodological approach for reporting	● operational leasing ● financial leasing	● operational leasing ● capital leasing ● leverage leasing (special approach for reporting by the lessor, if the relevant conditions are fulfilled)
The interest rate used to calculate the present value of the minimum lease payments by the lessee	Implicit interest rate, if it is known (if it is not so incremental interest rate primarily defined as ratio when using similar lease)	Lower from implicit interest rate and incremental rate of lessee (defined as interest from loan with similar risk)
Use of an option for extension	It is based on the original classification (operational, respectively financial leasing)	Required a new assessment (classification)
Depreciation of the lessee (finance lease)	Depreciation over the period of lease or the economic life, if it is shorter	Necessary depreciate over a period of capital lease
Complex of building and land	Separate assessment of lease of land and buildings	Reporting in one item, when the ratio of fair value of the land does not reach the fair value of the complex of determined limit (value of the land more than 25% of the total)
Sale and leaseback	There are criteria for evaluation as operational and financial lease. In the case of financial there is no reporting of purchase, asset remains reported on the side of seller. In the case of operational lease there are defined conditions for recognition of returns	Significance of this form is evaluated – has an impact on the recognition of return. Specific mode for real estates.
Scope of standards	IAS 17 deals with reporting of intangible assets	Intangible assets are completely excluded from the scope of standards

Source: Own processing according to relevant regulations

4 In the system IAS/IFRS it is IAS 17, IFRC 4 (determination whether the contract does not contain a lease), SIC 15 (operational lease incentives) and SIC 27 (evaluation of the substance of transactions concluded in the legal form of lease). In the US GAAP system it is mainly ASC40 that replaced FASB 13. Besides these there are a number of regulations and interpretation related to this issue.

Hsieh, and Su (2009), Abdel–Khalik, Rashad (1981), Weil (2004), Forsyth, Witmer, and Dugan (2005). The object of criticism is mainly the fact that the current approach to reporting leases may negatively affect the investment and financial decisions since very economically similar transactions can be, when using the current methodology, reported and evaluated in very different ways.

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[5] 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 leesee (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 capitalization[6].

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

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.

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 rate[7]. 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*

Date		Payment	Liability reduction	Interest	Interest per year	Liability	Amortization of right to use	Right to use netto
1. 1.	1.year					768 144		768 144
31. 3.	1. year	103 750	90 277	13 473	0	677 867		
30. 6.	1. year	103 750	91 861	11 889	0	586 006		
30. 9.	1. year	103 750	93 472	10 278	0	492 534		
31. 12.	1. year	103 750	95 111	8 639	44 279	397 422	384 072	384 072
31. 3.	2. year	103 750	96 780	6 970	0	300 643		
30. 6.	2. year	103 750	98 477	5 273	0	202 166		
30. 9.	2. year	103 750	100 204	3 546	0	101 962		
31. 12.	2. year	103 750	101 962	1 788	17 577	0	384 072	0

Source: authors' own work

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 use rights amortization and financial

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

Item	1. 1. 1. y.		31. 12. 1. y.		31. 12. 2. y.	
	CA[1]	ND	CA	ND	CA	ND
Total assets	26 926	27 694	36 653	37 037	56 178	56 178
Fixed assets:	5 023	5 791	6 349	6 733	6 521	6 521
Intangible fixed assets	0	768	0	384	0	0
Tangible fixed assets	5 023	5 023	6 349	6 349	0	0
Long-term financial assets	0	0	0	0	0	0
Current assets:	21 534	21 534	29 542	29 542	49 187	49 187
Inventory	539	539	798	798	798	798
Long-term receivables	0	0	0	0	0	0
Short-term receivables	17 902	17 902	15 131	15 131	32 044	32 044
Short-term financial assets:	3 093	3 093	14 079	14 079	17 277	17 277
Cash	517	517	83	83	2 126	2 126
Bank accounts	2 576	2 576	13 530	13 530	14 219	14 219
Accruals	369	369	762	762	470	470
TOTAL LIABILITIES AND EQUITY	26 926	27 694	36 653	37 037	56 178	56 178
Equity:	13 888	13 888	17 704	17 701	25 044	25 044
Registered capital	960	960	960	960	960	960
Reserve funds, statutory reserve account for cooperatives and other retained earnings	192	192	192	192	192	192
Profit/loss previous year	9 580	9 580	12 736	12 736	17 435	17 432
Profit/loss current year	3 156	3 156	3 816	3 813	6 457	6 457
Other sources:	12 939	13 707	18 949	19 346	31 134	31 134
Provisions	0	0	0	0	0	0
Long-term payables	0	397	0	0	0	0
Short-term payables	12 939	13 310	17 238	17 635	27 365	27 365
Estimated payables		0	0	253	0	0
Bank loans and fin.accomodations	0	0	1 711	1 711	3 769	3 769
Accruals	99	99	0	0	0	0

Source: authors' own calculation based on real financial statements

8 CA = current approach, ND = new draft

IV: *The comparative income statements under the application of both methodological approaches to lease reporting*

Item	31. 12. 1. y.		31. 12. 2. y.	
	CA	ND	CA	ND
Total revenues:	73 439	73 439	105 904	105 904
Revenues from sold goods	10 994	10 994	18 261	18 261
Expenses on sold goods	7 050	7 050	17 327	17 327
Sale margin	3 944	3 944	934	934
Production	62 445	62 445	87 643	87 643
Revenues form own products and services	62 445	62 445	87 643	87 643
Production consumption	58 422	58 422	75 320	75 320
Consumption of material and energy	7 012	7 012	7 962	7 962
Services	51 876	51 451	67 824	67 399
Added value	7 967	7 967	13 257	13 257
Personnel expenses:	1 851	1 851	2 420	2 420
Wages and salaries	1 312	1 312	1 912	1 912
Social security expenses and health insurance	527	527	496	496
Other social expenses	12	12	12	12
Taxes and fees	98	98	99	99
Depreciation and amortization	1 280	1 664	1 219	1 603
Revenues from disposals of fixed assets and materials	64	64	38	38
Changes in provisions and adjustments and complex deferred costs	–401	–401	0	0
Other operating revenues	80	80	929	929
Other operating expenses	56	56	748	748
Operating profit/loss	4 761	5 652	9 272	10 163
Interest revenues	1	1	3	3
Interest expenses	39	83	124	142
Other financial revenues	658	658	78	78
Other financial expenses	581	581	414	414
Financial profit/loss	39	–5	–457	–475
Income tax from operating aktivity	1 268	1 268	2 471	2 471
Due tax	1 268	1 268	2 471	2 471
Tax deferred	0	0	0	0
Profit/loss (regular activity)	3 532	3 529	6 344	6 367
Extraordinery revenues	284	284	113	113
Extraordinery expenses	0	0	0	0
Extraordinery profit/loss	284	284	113	113
Profit/loss	3 816	3 813	6 457	6 480

Source: authors' own calculation based on real financial statements

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

V: *Comparison of the structure of the balance sheet (vertical analysis) under the application of both methodological reporting practices*

Item.	1. 1. 1. y.		31. 12. 1. y.		31. 12. 2. y.	
	CA	ND	CA	ND	CA	ND
TOTAL ASSETS	100	100	100	100	100	100
Fixed assets:	18.65	20.91	17.32	18.17	11.61	11.61
Intangible fixed assets	0.00	2.77	0.00	1.04	0.00	0.00
Tangible fixed assets	18.65	18.14	17.32	17.14	0.00	0.00
Current assets:	79.97	77.76	80.60	79.77	87.56	87.56
Inventory	2.00	1.95	2.18	2.15	1.42	1.42
Long-term receivables	0.00	0.00	0.00	0.00	0.00	0.00
Short-term receivables	66.49	64.64	41.28	40.84	57.04	57.04
Short-term financial assets:	11.49	11.17	38.41	38.00	30.75	30.75
Cash	1.92	1.87	0.23	0.24	3.78	3.78
Bank accounts	9.57	9.30	36.91	36.52	25.31	25.31
Accruals	1.37	1.33	2.08	2.06	0.84	0.84
TOTAL LIABILITIES AND EQUITY	100.00	100.00	100.00	100.00	100.00	100.00
Equity:	51.58	50.15	48.30	47.78	44.58	44.58
Registered capital	3.57	3.47	2.62	2.59	1.71	1.71
Reserve funds. statutory reserve account for cooperatives and other retained earnings	0.71	0.69	0.52	0.52	0.34	0.34
Profit/loss previous year	35.58	34.59	34.75	34.38	31.04	31.03
Profit/loss current year	11.72	11.40	10.41	10.29	11.49	11.49
Other sources:	48.05	49.49	51.70	52.22	55.42	55.42
Long-term payables	0.00	1.43	0.00	0.00	0.00	0.00
Short-term payables	48.05	48.06	47.03	47.60	48.71	48.71
Estimated payables	0.00	0.00	0.00	0.71	0.00	0.00
Bank loans and fin.accomodations	0.00	0.00	4.67	4.62	6.71	6.71
Accruals	0.37	0.36	0.00	0.00	0.00	0.00

Source: authors' own calculation based on real financial statements

VI: *Comparison of the cost structure (vertical analysis) under the application of both methodological reporting practices*

	31. 12. 1. y.		31. 12. 2. y.	
	CA	ND	CA	ND
Expenses on sold goods	5.42	5.42	9.85	9.85
Production consumption	44.90	44.90	42.83	42.83
Consumption of material and energy	5.39	5.39	4.53	4.53
Services	39.87	39.54	38.56	38.33
Personnel expenses	1.42	1.42	1.38	1.38
Wages and salaries	1.01	1.01	1.09	1.09
Social security expenses and health insurance	0.41	0.41	0.28	0.28
Other social expenses	0.01	0.01	0.01	0.01
Taxes and fees	0.08	0.08	0.06	0.06
Depreciation and amortization	0.98	1.28	0.69	0.91
Other operating cosi	0.04	0.04	0.43	0.43
Interest expenses	0.03	0.06	0.07	0.08
Other financial expenses	0.45	0.45	0.24	0.24

Source: authors' own calculation based on real financial statements

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

VII: *Selected Financial Analysis Ratios*

Ratio	1. year CA	1. year ND	2. year CA	2. year ND
ROA	10.41115325	10.29233136	11.4938232	11.5347645
ROE	21.55445097	21.54115587	25.78262258	25.87446095
Current Ratio	1.713771899	1.675191381	1.797441988	1.797441988

Source: authors' own calculation based on real financial statements

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

VIII: *Expected impact of applying the new concept to the values of selected financial ratios*

Ratio	Definition	impact on the value of the ratio under the new approach in comparison to current approach
ROA	EBIT/total assets	Decrease. Increasing tendency during the lease term
Total assets turnover	Sales/ total assets	Deterioration
Current ration	Current assets/short term liabilities and short term bank loans	Decrease. Improving during a lease term
Debt equity	Liabilities/ equity	Increase
Interest coverage	EBIT/interest costs	Decrease. Improving during a lease term

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 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.

Acknowledgement

The results introduced in this paper are a part of research project supported by Czech Science Foundation via grant No. GAP403/11/0849 with the title US GAAP and IAS/IFRS convergence with respect to the adjustment of methodical procedures of the financial analysis.

REFERENCES

ABDEL–KHALIK, A., RASHAD, D., 1981: The economic effects on lessees of FASB Statement No. 13 – Accounting for Leases, Stamford. CT: FASB. W. ISBN.

BEATTIE, V., GOODACRE, V., Thomson, J., 2000: Operating leases and the assessment of lease-debt substitutability, Journal of Banking and Finance 24. 427–470. ISSN 0378–4266.

BEATTIE, V., GOODACRE, A., THOMSON, S. J., 2006: International lease-accounting reform and economic consequences: The views of UK users and preparers, International Journal of Accounting 41, 2006. 75–103. ISSN 0020–7063.

BENNETT, B. K., BRADBURY, M. E., 2003: Capitalizing non-cancelable operating leases, Journal of International Financial Management and Accounting 14, 101–114. ISSN 1467–646X.

BRICE, S., 2011: IFRS and U.S. GAAP Convergence – Delays Upon Delays, CPA Insider. [online]. Available on http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/CPA/Aug/IFRSGAAP.jsp. Cit. 2012-0611.

Deloitte, 2012: Účetní zpravodaj Deloitte: [online]. Available on http://www.deloitte.com/assets/Dcom–CzechRepublic/Local%20Assets/Documents/Accounting%20News/ucetni_zpravodaj_0904.pdf. Cit 20120612.

DUROCHER, S., 2005: The capitalization of operating leases: A Canadian study, EAA paper on 28th EAA annual congress in Gothenburg, Sweden. On-line. W. ISBN.

Ernst &Young, 2011: Srovnávací studie o stavu aplikace IFRS u nekotovaných společností v šesti evropských státech. [online]. Available on http://www.mfcr.cz/cps/rde/xbcr/mfcr/Comparative_study_CZ.pdf.

FINNERTY, J. E., FITZSIMMONS, R. N., OLIVER, T. W., 1980: Lease capitalization and systematic risk, Accounting Review 55, 1980, p. 631–639. ISSN 1835-2561.

FORSYTH, T. B., WITMER, P. R., DUGAN, M. T., 2005: Accounting Standards Setting: Inconsistencies in Existing GAAP. [online]. The CPA Journal. May 2005. Available on http://www.nysscpa.org/cpajournal/2005/505/essentials/p28.htm.

HOULIHAN, W. A., SONDHI, A. C, 1984: De facto capitalization of operatingleases: The effect on debt capacity, Corporate Accounting 2, p. 3–13. ISSN 1097-0053.

IMHOFF, E. A., LIPE, R. C., WRIGHT, D. W., 1993: The effects of recognition versus disclosure on shareholder risk and executive compensation, Journal of Accounting, Auditing and Finance 8, p. 51–63. ISSN 1097-0053.

IMHOFF, E. A., LIPE, R. C., WRIGHT, D. W., 1997: Operating leases: Income effects of constructive capitalization, Accounting Horizons 11, p. 12–32. ISSN 0888-7993.

IMHOFF, E. A., THOMAS, J. K., 1988: Economic consequences of accounting standards: The lease disclosure rule change, Journal of Accounting and Economics 10 P. 277–310. ISSN 0165–4101.

IASB: ED – Leases, 2010: Available on http://www.ifrs.org/NR/rdonlyres/C03C9E95–822E–4716–81ED–04B9CC4943BE/0/EDLeasesStandard0810.pdf Cit. 20110807.

IASB: IFRS: A guide through International Financial Reporting Standards (IFRSs) 2008: including the full text of the Standards and Interpretations and accompanying documents issued by the International Accounting Standards Board as approve date 1 July 2008: with extensive cross-references and other annotations. London: International Accounting Standards Committee Foundation, 2008. 2827 s. ISBN 978–1–905590–68–1.

IASB: Lease – Preliminary View (2010). [online] Available on http://www.iasb.org/NR/rdonlyres/FF3A33DB–E40D–4125–9ABD–9AF51EB92627/0/DPLeasesPreliminaryViews.pdf. Cit. 20110810.

JOANNE, C., DUKE, A., HSIEH, A., YULI, S., 2009: Operating and synthetic leases: Exploiting financial benefits in the post-Enron era. Advances in Accounting. Volume 25, Issue 1, p. 28–39. ISSN 1085-4622.

LIPE, R. C., 2001: Lease accounting research and the G4+1 proposal, Accounting Horizons 15, p. 299–310. ISSN 0888-7993.

Mc GREGOR, W., 1996: Accounting for leases: A new approach, Norwalk, CT: FASB. Moody's (1999):, Off-balance sheetleases: Capitalization and ratingsimplications – Outofsight but not outof mind, New York, NY: Moody's Investor Service. w. ISBN.

MLÁDEK, R., 1998: Světové účetnictví, Praha, Linde. ISBN 80-7201-109-X.

NOBES, C. W., 2005: Rules–Based Standards and the Lack of Principles in Accounting, Accounting Horizons. ISSN 0888-7993.

SANNELLA, A., 1989: The capitalization of operating leases: The discounted cash flow approach, Journal of Commercial Bank Lending 72, 1989, p. 49–55. ISSN 0021-986X.

VANĚK, M., 2003: Německé účetní právo v české praxi. Praha: Linde, 86 p. ISBN 80-86131-41-6.

WILKINS, TREVOR A., 1984: A behavioural investigation of alternative methods of financing capital acquisitions and lease capitalization, Accounting and Business Research 14, p. 359–366. ISSN 2159-4260.

WILKINS, T. A., ZIMMER, I., 1983: The effect of leasing and different methods of ccounting for leases on credit evaluations, Accounting Review 58. p. 749–764. ISSN 1835-2561.

WEIL, J., 2004: How Leases Play A Shadow Role In Accounting. The Wall Street Journal [online]. Available on http://latrobefinancialmanagement.com/Research/Accounting/How%20Leases%20Play.pdf 22.8.2004. cit. 20120614.

Address

doc. Ing. Patrik Svoboda, Ph.D., doc. Hana Bohušová, Ph.D., Ústav účetnictví a daní PEF, Mendelova univerzita v Brně, Zemědělská 1, 613 00 Brno, Česká republika, e-mail: patrik.svoboda@mendelu.cz, hana.bohusova@mendelu.cz