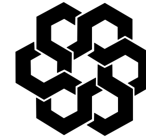

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **20 November 2008, London**

Project: **LEASE ACCOUNTING**

Subject: **Subsequent Measurement (Agenda Paper 8B)**

Introduction

1. At the July 2008 Board meetings, the boards discussed the subsequent measurement of the lessee's right-of-use asset and obligation to pay rentals.

2. The IASB reached a preliminary view that a lessee should amortize the right-of-use asset on a systematic basis over the shorter of the lease term and the economic life of the leased asset; however, for leases in which it is expected that the lessee will obtain title at the end of the lease term, the amortization period would be the economic life of the leased item. The IASB also reached a preliminary view that a lessee should apportion the lease payments between a finance charge and a reduction of the outstanding liability. Amortization/depreciation expense and interest expense would be presented in the income statement.

3. The FASB discussed the subsequent measurement of both the right-of-use asset and the lease obligation, but was not able to reach a preliminary view because there was some support for recognizing rental expense in the income statement instead of amortization and interest expense.

4. At the October 2008 Leases Working Group Meeting, the staff received input from working group members that prior to issuing a Discussion Paper, the boards should attempt to:

   (a) reach converged preliminary views wherever possible, and

   (b) clarify the discussion of the alternate approach that would link the subsequent measurement of the right-of-use asset to the obligation to pay rentals (with examples).

5. The purpose of this paper is to get preliminary views on the subsequent measurement of the lessee's right-of-use asset and its obligation to pay rentals. Specifically, the staff will seek preliminary views on the following:

   (a) subsequent measurement of the lessee's right-of-use asset and obligation to pay rentals (FASB)

   (b) reassessment of the lease term

   (c) reassessment of the lessee's obligation to pay rentals.

Subsequent measurement of the lessee's right-of-use asset and obligation to pay rentals

6. The boards previously considered the following three approaches for subsequently measuring the lessee's right-of-use asset and obligation to pay rentals:

   (a) measure the right-of-use asset and the obligation to pay rentals at fair value;

   (b) amortize/depreciate the right-of-use asset, apportion the lease payments between a finance charge and a reduction of the outstanding obligation, and present interest expense and amortization/depreciation in the income statement; and

   (c) link the subsequent measurement of the right-of-use asset and the obligation to pay rentals (amortize the right-of-use asset using interest-based amortization, reduce the obligation to pay rentals on a mortgage-type basis, and present rental expense in the income statement).

7. Both boards tentatively decided not to require fair value measurement of the lessee's right-of-use asset or obligation to pay rentals either at initial measurement or at subsequent measurement. As the IASB has already reached a preliminary view on the subsequent measurement of the right-of-use asset and obligation to

pay rentals, the first analysis in this paper is for the FASB to reach a preliminary view on the subsequent measurement of the right-of-use asset and obligation to pay rentals. (The next section of the paper, addressing reassessment of the lease term, begins with paragraph 31).

Approach A – Amortize/depreciate the right-of-use asset, apportion the lease payments between a finance charge and a reduction of the outstanding obligation, and present interest expense and amortization/depreciation in the income statement

8. This approach, which is the preliminary view of the IASB, would amortize the right-of-use asset over the shorter of the lease term and the economic life of the leased asset based upon the pattern of consumption of economic benefits embodied in the right-of-use asset. For leases of items where it is expected that the lessee will obtain title at the end of the lease term, the amortization period would be the economic life of the leased item. This is consistent with existing lease accounting standards that require subsequent measurement of the leased asset on an amortized cost basis.
9. This approach would also apportion the lease payment between a finance charge and the reduction of the outstanding liability. The finance charge would be allocated to each period during the lease term so as to provide a constant periodic rate of interest on the remaining balance of the liability. This is consistent with the subsequent measurement requirements of existing lease accounting standards for lessees with finance leases.
10. This approach accounts for the lessee's obligation to pay rentals as the acquisition of debt. It also is consistent with the effective interest method required by current accounting standards for financial liabilities not measured at fair value. Subsequent accounting for financial liabilities not measured at fair value follows an effective interest method of calculating the amortised cost and allocates the interest expense over the relevant period (the lease term, in this case).
11. In the discussion on subsequent measurement at the July 2008 FASB meeting, one FASB member stated that the costs to preparers associated with calculating interest expense would outweigh the benefits to users for short-term leases.

Another FASB member noted that feedback from users and the lease working group would help them decide whether to require interest expense to be calculated.

12. The staff discussed this issue with rating agencies who indicated that they treat all leases as capital leases and recognize interest expense, rather than rent expense. The rating agencies adjust their financial statements to re-allocate the income statement expense from rental expense to amortization and interest expense.

13. However, it should be noted that certain users of financial statements specifically stated in the FASB financial guarantee project that they did not want to break out interest expense.

14. At the October 2, 2008 CFA Institute Corporate Disclosure Policy Committee meeting with the FASB, committee members reported to the FASB staff their views that all lease obligations should be amortized like any other liability with portions of each payment going to interest and amortization. They did not support an approach that would apportion lease payments to rental expense.

15. At the October 2008 working group meeting, several working group members noted that a lease obligation was economically similar to any other debt and therefore recommended that it be accounted for accordingly. As such, those working group members generally supported amortizing the obligation with a charge to interest expense.

16. Other working group members consider that there is a fundamental difference between a lease that conveys the right to use an asset for a limited period of time and a lease that is used to achieve an in-substance acquisition of an asset by the lessee. Those working group members would support approach A only for those leases that are used to achieve an in-substance acquisition of an asset by the lessee.

17. Constituents have noted that a consequence of a decision by the boards to require recognition of depreciation expense and interest expense, rather than rent expense, for leases currently classified as operating is that earnings before interest, taxes, depreciation, and amortization (EBITDA) will increase for many lessees. This is because rent expense is currently a reduction of EBITDA while depreciation expense and interest expense are excluded. While the staff does not believe that

the boards should set accounting rules based on the components of a ratio or an earnings metric, the staff believes the boards should be aware of this consequence.

Approach B – link the subsequent measurement of the right-of-use asset and the obligation to pay rentals (amortize the right-of-use asset using interest-based amortization, reduce the obligation to pay rentals on a mortgage-type basis, and present rental expense in the income statement).

18. Under this approach, the right-of-use asset would be amortised using mortgage-based amortisation using the lessee's incremental borrowing rate. Subsequent measurement of the liability would be consistent with current finance lease accounting (reducing the obligation at each accounting period under a mortgage amortisation model). Therefore, the subsequent measurement (reduction) of the right-of-use asset and the obligation to pay rentals would be the same. This would generally result in the asset and liability balance remaining equal over the lease term (assuming even payments over the lease term, no asset impairment, etc.).

19. Under this approach, the lease payment would not be split into principal and interest components. Rental payments made in each accounting period would be included as an expense in the income statement on a straight-line basis over the lease term unless another systematic approach is more representative of the pattern of use. This approach would leave the income statement impact for operating leases the same as under current operating lease guidance. The argument for this approach is that the economic benefits of a lease are consumed as rental payments are made. In the case of a straightforward lease contract, the lessee is paying for the right to use the asset at the same time as it (a) receives this right and (b) consumes its economic benefits.

20. Some constituents believe this linked methodology reflects the underlying economics in a decision-useful manner. Lease pricing for operating leases involves pricing that results in level rent expense over the lease term. This approach results in the lessee recognising these level rentals in the income statement over the lease term. Constituents supporting approach B do not see any justification for discounting the asset on a straight-line basis while reversing the discounting relating to the liability on a financial basis.

21. This approach is simpler for lessees to apply than a non-linked approach and, in some jurisdictions, would align the profit and loss effect and the tax treatment of these leases.

22. Approach B is based on the notion that there is a fundamental difference between a lease that conveys the right to use an asset for a limited period of time and a lease that is used to achieve an in-substance acquisition of an asset by the lessee. This approach would apply to those leases that convey the right to use an asset for a limited period of time. The expense recognition would reflect the constant periodic cost that results from the rental contract. Constituents supporting this approach note that if current finance lease rules for the asset and liability are applied to leases that are not in-substance purchases:

    (a) the cost pattern will not reflect the substance of the lease,

    (b) this approach will create a new book-to-tax temporary difference (at least for leases in the US), which does not currently exist for those leases currently classified as operating leases, and

    (c) the pattern will recognize higher expense in the early periods than in the later periods (the distortion is greater the longer the lease term).

23. In addition, constituents supporting this approach state that in the case of leases that are not in-substance purchases, the economics are that the rights are not ownership rights and the asset and the liability are inextricably linked; that is, neither can be settled without settling the other and their value is the same. That is, the value of the leased asset is the present value of the cash flow of a replacement lease while the value of the liability is the present value of the remaining payments. This is in contrast to a loan that is used to purchase as asset. The loan and the asset have two distinct sources while the assets and the liabilities associated with a lease arise from the same original contract.

24. It seems if the initial carrying amounts of the right-of-use asset and the obligation to pay rentals are determined on the same basis, it is logical that subsequent carrying amounts also be determined on that same basis.

Illustrative examples

25. Appendix 1 to this paper shows two examples, a 10-year office space lease and a 3-year computer lease, comparing the two approaches described above.

26. The examples illustrate the additional deferred tax entry required (at least in the United States) if the current finance model is used. Some feel this is an unnecessary compliance burden caused by an expense pattern that does not reflect the substance of the lease. Therefore, in some jurisdictions (for example, the US) this approach would simplify the deferred tax treatment of some types of leases.

27. Most importantly the example shows the higher expense recognition – in the case of the real estate lease the cost recognized in the first year is 21% higher if capital lease accounting is used versus the alternate approach. Of course, the variance would be greater in the case of longer leases which are common in the real estate and large ticket equipment lease markets.

Staff recommendation

28. The staff notes that the right-of-use asset and the obligation to make pay rentals is initially measured by the liabilities incurred and the consideration payable that is negotiated in the lease contract. However, after initial recognition, the lease asset and liability should be accounted for subsequently in the statement of financial position and the income statement according to accounting standards dealing with assets and liabilities respectively. Therefore, lease assets would be amortized based upon the pattern of consumption of economic benefits embodied in the right-of-use asset. Lease liabilities would be accounted for as debt.

29. The staff recommends that the lessee's right of use asset be amortized over the shorter of the lease term and the economic life of the leased asset based upon the pattern of consumption of economic benefits embodied in the right-of-use asset. For leases of items where it is reasonably certain that the lessee will obtain title at the end of the lease term, the amortisation period would be the economic life of the leased item. This is consistent with the subsequent measurement of other assets recognized on an accumulated cost basis.

30. The staff also recommends that the lessee's obligation to pay rentals be apportioned between a finance charge and a reduction of the outstanding liability, consistent with the current treatment of finance leases. The finance charge would be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Question 1 – Do board members agree that the subsequent measurement of the lessee's right-of-use asset and obligation to pay rentals should be accounted for as follows:

(a) amortize/depreciate the right-of-use asset

(b) apportion the lease payments between a finance charge and a reduction of the outstanding obligation

(c) present interest expense and amortization/depreciation in the income statement?

Reassessment of the lease term

31. Current lease accounting standards do not require reassessment of the lease term unless particular conditions are met (for example, the terms of the lease are changed). Consequently, the initially recognised assets and liabilities are not usually adjusted for changes in the assessed lease term.

32. The boards have tentatively decided not to recognize options to extend or terminate a lease separately from the right-of-use asset. Instead, the boards have proposed that the assets and the liabilities recognized by the lessee be based upon an assessment of the lease term. The boards tentatively decided that the assessed lease term be based upon the lessee's best estimate.

33. Purchase options could be viewed as the "ultimate renewal option" because a purchase option is no different than providing renewals that extend over the entire economic life of the leased property. Consequently, the staff believes that purchase options should be treated in the same way as option to extend or terminate the lease.

34. The boards should address whether the lessee should reassess the lease term after initial recognition. The staff considers assessing the initial lease term (including the assessment of renewal options and purchase options in that initial assessment) is a recognition question, as opposed to measurement. Once the initial lease term is determined, rental payments for that lease term are considered in measuring the right-of-use asset and obligation to pay rentals. The boards need to decide if the lease term should be subsequently reassessed, which will then have an effect on the subsequent rental payments.

Staff recommendation

35. The staff recommends that the lease term be reassessed at each reporting date to determine the best estimate of the expected lease term. Because there will be many assumptions when initially determining the best estimate of the lease term, allowing a reassessment of the lease term will provide a more refined best estimate of the lease term each reporting period. Whether a purchase option will or will not be exercised should also be reassessed.

36. Changes in estimates of the lease term are likely to provide users of the financial statements with more timely and relevant information. However, requiring reassessment of the lease term in more complex and is likely to be more costly for preparers.

Question 2 – Do board members agree with the staff recommendation?

Reassessment of lessee's obligation to pay rentals

37. Agenda paper 8A (FASB memorandum No. 22) recommends that the obligation to pay rentals include a best estimate of the amounts payable under the lease contract. For example, the boards have already reached a preliminary view that contingent rentals should be included in the initial measurement of the lessee's obligation to pay rentals.

38. Circumstances or events that occur subsequent to initial measurement could change the assumptions used to determine the best estimate of the lessee's obligation to pay rentals. The boards have not discussed whether to require a reassessment of the amounts payable under the lease contract subsequent to initial measurement. In addition, a change in the assessed term of a lease will result in a change in expected cash outflows over the lease term.

39. Therefore the staff notes that once the initial lease term is determined and once the initial measurement of the lessee's right-of-use asset and obligation to pay rentals has been determined, the lessee's obligation to pay rentals could change over the lease term due to one or some of the following occurring (or a change in the best estimate of whether one or some of the following might occur):

    (a) exercise of a renewal option

    (b) early termination of a lease

(c) exercise of a purchase option

(d) payment of contingent rent

(e) payment of a residual value guarantee

40. The boards should consider whether the obligation to pay rentals should be remeasured for changes in expected cash flows.

Approach A – do not remeasure obligations to pay rentals

41. IAS 17 and Statement 13 generally do not require reassessment of obligations to pay rentals.

42. For example, contingent rentals are generally expensed in the period incurred and excluded from the minimum lease payments that are used in the measurement of the initial finance lease asset and lease obligation. Statement 13 generally treats contingent rentals in a way that is consistent with IAS 17; however, an exception to expensing contingent lease payments as incurred is found in EITF Issue No. 98-9, "Accounting for Contingent Rent". Issue 98-9 requires an entity to accrue contingent rental expense prior to the future achievement of a specified target if it is considered probable that the entity will reach the target.

43. Statement 13 indicates that if the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments, the present balances of the asset and the obligations shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation.

44. IAS 17 and Statement 13 do not currently provide for a continual reassessment of the minimum lease payments over the lease term.

Approach B – remeasure obligations to pay rentals for changes in estimated future rentals

45. Under IFRS, whether they are carried at amortised cost or fair value, liabilities are generally remeasured for changes in expected cash outflows. For example, non-financial liabilities accounted for under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, are remeasured for changes in expected cash flows.

Remeasuring the liability to reflect current best estimates of rental payments is likely to provide users of the financial statements with more relevant information. However, requiring reassessment of obligations to pay rentals is more complex and is likely to be more costly for preparers.

Staff recommendation

46. Although the current lease accounting guidance does not require a reassessment of the obligation to pay rentals, the staff recommends that the obligation to pay rentals be reassessed at each reporting date over the lease term.

47. In addition, remeasuring the liability to reflect current best estimates of the lease term and current best estimates of the rental payments is likely to provide users of the financial statements with more relevant information. However, requiring reassessment of the rental payments is more complex and is likely to be more costly for preparers.

48. The staff believes that the benefit to users outweighs the cost to preparers.

Question 3 – Should obligations to pay rentals be reassessed at each reporting date over the lease term?

How to record changes in the estimated lease payments

49. Changes in the estimates of lease payments (due to changes in estimates of the lease term and changes in estimates of contingent rentals, purchase options, and residual value guarantees) will impact the lessee's obligation to pay rentals. The staff recommends that the boards treat changes in all of these estimates similarly; that is, develop one principle that will be applied to all changes in estimated cash flows.

50. If the boards have agreed that the right-of-use asset is to be accounted for under a cost accumulation model based on the estimated lease payments (and an interest method for subsequent accounting), then paragraph 97 of FASB Statement of Financial Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* identifies three different techniques that can be used to address changes in estimated cash flows under an interest method:

a. the prospective approach, where a new effective interest rate is computed based on the carrying amount and remaining cash flows.

b. the catch-up approach, where the carrying amount of the liability is adjusted to the present value of the revised estimated cash flows, discounted at the original effective interest rate.

c. the retrospective approach, where a new effective interest rate is computed based on the original carrying amount, actual cash flows to date, and remaining estimated cash flows. The new effective interest rate is then used to adjust the carrying amount to the present value of the revised estimated cash flows, discounted at the new effective interest rate.

51. In paragraph 98 of CON 7, the FASB indicates a preference for the catch-up approach. However, other approaches are used elsewhere in US GAAP. The catch-up approach is consistent with the effective interest method under IAS 39.

52. In CON 7, the FASB considers the catch-up approach to be preferable to other techniques for reporting changes in estimated cash flows "…because it is consistent with the present value relationships portrayed by the interest method and can be implemented at a reasonable cost."

Staff Recommendation

53. The staff recommends that a lessee's liability to the lessor be subsequently measured using the effective interest method (employing a "catch-up approach" for changes in cash flow estimates). The staff recommends this approach because it is more consistent with how similar financial liabilities are subsequently measured under existing IFRS and US GAAP, increasing the comparability of the financial reports. In addition, the catch-up approach is consistent with measuring the right-of-use asset and obligation to pay rentals at the present value of the estimated future cash flows discounted at the original effective interest rate. If a change in estimated future cash flows is effected through the catch-up approach, the measurement basis remains the same.

Question 4 – Do board members agree with the staff recommendation?

54. If the boards decide to require remeasurement of the obligation to pay rentals for changes in estimated cash flows, the boards will also need to determine how to

recognise the resulting difference in the measurement of the liability. There are two possible approaches:

(a) recognise any change in the liability in profit or loss

(b) recognise any change in the liability as an adjustment to the carrying value of the right-of-use asset.

Recognise any change in the liability in profit or loss

55. In general, a change in a recognised liability would not result in a change in the carrying value of an asset. Recognising any change in the obligation to pay rentals in profit or loss would be consistent with the treatment of other contingent liabilities and many financial liabilities. For example, changes in an obligation to pay contingent consideration arising from a business combination are recognised in profit or loss.

56. In addition, a change in the obligation to pay lease rentals (subsequent to the initial measurement) may not indicate an increase in the value of the right-of-use asset. For example, an increase in an obligation to pay rentals arising from an increase in market interest rates may not indicate an increase in the value of a right to use a retail property.

57. Proponents for recording a change in the lease payments directly to the income statement would treat changes in the rental payments as changes in estimate to be recorded as incurred through the income statement.

58. This is consistent with the FASB's view in Statement 163, *Accounting for Financial Guarantee Insurance Contracts*, where "revisions to the claim liability in periods after initial recognition shall be recognized as claim expense in the period of the change (as a change in accounting estimate)". It is also consistent with paragraph AG8 of IAS 39.

Recognise any change in the liability as an adjustment to the carrying value of the right-of-use asset

59. In lease contracts, there is a clear link between the right-of-use asset and the obligation to pay rentals. Because the initial measurement of the right-of-use asset is determined based on the obligation to pay rentals, a change in the liability can

be viewed as a change to the originally estimated cost of the right-of-use asset. In addition, if the original estimate of contingent rentals were correct, the future changes in the liability would have been included in the original asset. This is similar to the approach adopted for decommissioning liabilities under IFRIC 1, *Changes to Existing Decommissioning, Restoration and Similar liabilities* and FASB Statement No. 143 *Accounting for Asset Retirement Obligations*, where the carrying value of the recognised asset is adjusted for changes in a decommissioning liability.

60. This view is based on the notion that additional (or lower) "costs" (rental payments) are tied to the cost of acquiring the right-of-use asset, similar to asset retirement obligations. Current US GAAP would account for the debit arising on recognition of additional liabilities as part of the right-of-use asset because these costs are integral to or are a prerequisite for operating the leased item. Statement 13, states, in part:

> …if the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments…the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments …shall be computed using the rate of interest used to record the lease initially.

Staff recommendation

61. The staff recommends that changes to estimated rental payments be accounted for similarly (whether it is a change to the estimated lease term or changes in estimates of contingent rentals, purchase options, residual value guarantees, etc.). The boards have decided to adopt a single asset and liability approach to the right-of use asset and obligation to pay rentals rather than a component based approach. Under the single asset and liability approach, contingent rentals for example, are not recognized separately. All lease payments would be taken into account and all changes in estimates to all lease payments would be reassessed each reporting period. The staff also recommends that any change in the liability as a result of a

change in the estimated rental payments should be recognised as an adjustment to the carrying value of the right-of-use asset.

Question 5 – Do board members agree that changes to rental payments be accounted for similarly (changes in lease term, contingent rentals, purchase options, residual value guarantees, etc)?

Question 6 – Do board members agree that any change in the liability as a result in a change in the estimated rental payments should be recognized as an adjustment to the carrying value of the right-of-use asset?

APPENDIX 1 – EXAMPLES

62. Two examples are presented below – a 10-year office space lease and a 3-year computer lease. The examples show the terms, journal entries and comparative financial statements.

63. The examples demonstrate the difference in accounting between an allocation to amortization and interest expense (Approach A) versus rental expense (Approach B).

64. The deferred tax accounting shown in the examples is based upon US GAAP requirements and assumes that the lessee receives a tax deduction for the amount of the rental payments.

Office space lease

Square feet	15,000
Rent rate per sq ft	30
Annual rent in $	450,000
Payment timing	arrears
Term in years	10
Inception month	January
Lessee incr borrowing rate	8.00%
PV of rents	3,019,537
Annual tax deduction	450,000
Incremental income tax rate	40.00%

Journal entries

Capital lease accounting

dr Equipment	3,019,537	
cr Capitalized lease obligation		3,019,537
To capitalize the lease		
dr Depreciation expense	301,954	
cr Accumulated depreciation		301,954
To depreciate the asset 1st mo		
dr Interest expense	241,563	
dr Capitalized lease obligation	208,437	
cr Cash		450,000
to record 1st mo rent, cap lease obligation amort & imputed int		
dr Current taxes payable	37,407	
cr Deferred taxes payable		37,407
To record tax impact of temporary book/tax difference		

Alternate approach

dr Right to use equipment	3,019,537	
cr Capitalized lease obligation		3,019,537
To capitalize the lease		
dr Capitalized lease obligation	208,437	
cr Rent expense		208,437
dr Rent expense	208,437	
cr Right to use equipment		208,437
To amortize 1st year right to use asset & lease obligation		
dr Rent expense	450,000	
cr Cash		450,000
To pay 1st year rent ad record rent expense		

Comparative Financial Statements

Capital lease accounting

Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
Equipment	2,717,583	2,415,629	2,113,676	1,811,722	1,509,768	1,207,815	905,861	603,907	301,954	-
Cap lease obligation	2,811,100	2,585,988	2,342,867	2,080,296	1,796,720	1,490,457	1,159,694	802,469	416,667	0
Deferred tax liability	37,407	68,143	91,676	107,430	114,780	113,057	101,533	79,425	45,885	0
P&L										
Depreciation	301,954	301,954	301,954	301,954	301,954	301,954	301,954	301,954	301,954	301,954
Interest expense	241,563	224,888	206,879	187,429	166,424	143,738	119,237	92,775	64,198	33,333
Tax expense	217,407	210,737	203,533	195,753	187,351	178,276	168,476	157,892	146,460	134,115
Net after tax income	326,110	316,105	305,300	293,630	281,026	267,415	252,714	236,837	219,691	201,172

Alternate approach

Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
Right to use equip	2,811,100	2,585,988	2,342,867	2,080,296	1,796,720	1,490,457	1,159,694	802,469	416,667	0
Cap lease obligation	2,811,100	2,585,988	2,342,867	2,080,296	1,796,720	1,490,457	1,159,694	802,469	416,667	0
P&L										
Rent expense	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000
Tax expense	180,000	180,000	180,000	180,000	180,000	180,000	180,000	180,000	180,000	180,000
Net after tax income	270,000	270,000	270,000	270,000	270,000	270,000	270,000	270,000	270,000	270,000
Difference in net AT Income	56,110	46,105	35,300	23,630	11,026	(2,585)	(17,286)	(33,163)	(50,309)	(68,828)
Difference in AT income	20.78%	17.08%	13.07%	8.75%	4.08%	-0.96%	-6.40%	-12.28%	-18.63%	-25.49%

Computer workstation lease

Equipment cost	4,000
Term in months	36
Lessor's residual	15%
Monthly rent in $	110.54

Monthly rent % equip cost	2.76%
Payment timing	arrears
Lessee incr borrowing rate	8.00%
PV of rents	3,527.53
% of asset cost	88.19%
Delivery month	January
Monthly tax deduction	110.54
Incremental income tax rate	40.00%

Journal entries

Capital lease accounting

dr Equipment	3,527.53	
cr Capitalized lease obligation		3,527.53

To capitalize the lease

dr Depreciation expense	97.99	
cr Accumulated depreciation		97.99

To depreciate the asset 1st mo

dr Interest expense	23.52	
dr Capitalized lease obligation	87.02	
cr Cash		110.54

to record 1st mo rent, cap lease obligation amort & imputed int

dr Current taxes payable	4.39	
cr Deferred taxes payable		4.39

To record tax impact of temporary book/tax difference

Alternate approach

dr Right to use equipment	3,527.53	
cr Capitalized lease obligation		3,527.53

To capitalize the lease

dr Capitalized lease obligation	87.02	
cr Rent expense		87.02
dr Rent expense	87.02	
cr Right to use equipment		87.02

To amortize 1st mo right to use asset & lease obligation

dr Rent expense	110.54	
cr Cash		110.54

To pay 1st mo rent and record rent expense

Comparative Financial Statements

Capital lease accounting				Alternate approach			
Balance sheet	**YR 1**	**YR 2**	**YR 3**	**Balance sheet**	**YR 1**	**YR 2**	**YR 3**
Equipment	2,352	1,176	-	Right to use equip	2,444	1,271	(0)
Cap lease obligation	2,444	1,271	(0)	Cap lease obligation	2,444	1,271	(0)
Deferred tax liability	15	15	(0)	Deferred tax liability	-	-	-
P&L				**P&L**			
Depreciation	1,176	1,176	1,176	Rent expense	1,326	1,326	1,326
Interest expense	243	153	56				
Tax expense	568	532	493	Tax expense	531	531	531
Net after tax	851	797	739	Net after tax	796	796	796
				Diff in AT income	55	1	(57)
				% difference	6.97%	0.19%	-7.15%