THE IMPACT OF THE PROPOSED STANDARD ON ACCOUNTING FOR LEASES ON REPORTED EARNINGS OF U.S. COMPANIES

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ABSTRACT

The purpose of this paper is to examine the proposed "principles-based" standard for accounting for leases that the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently finalizing. This standard will be the first joint project undertaken by the two standard-setting bodies as they work towards a set of converged standards for the future. The current accounting standard in the U.S. is believed to be a perfect example of a "rules-based" standard that is open to manipulations. The proposed standard is designed to be "principles-based" allowing for the accountants' and auditors' judgmental determination of whether a lease should be accounted for as a capital lease or an operating lease. In this paper we examine the provisions of the proposed standard to study the impact on the reported earnings of U.S. companies.

Current accounting rules in U.S. distinguish between operating and capital leases on the basis of four very detailed criteria. If all four criteria are met, the lease is classified as a capital lease, resulting in the recognition of an asset and a liability in the financial statements. If any of the criteria are not met, the lease is classified as an operating lease which results in the payments being accounted for as rent expenses in the financial statement. As the criteria are very prescriptive, some critics of this standard believe it provides companies with an easy way to "design" the lease to avoid recognizing a long-term liability in the financial statement. In the wake of the financial reporting scandals at the turn of the century, some of the manipulations discovered involved leases.
As the proposed standard will severely limit the recognition of operating leases, companies that currently use this method may to change the accounting treatment to recognizing capital leases. As yet, no study has examined the impact this change will have on the reported financial position of companies currently reporting operating leases. We identify U.S public companies reporting rent expenses for leases and run proforma changes to the capital leases method to examine the changes this results in their reported earnings and the financial position.

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