Review of Business & Finance Studies
Vol. 11, No. 1, 2020, pp. 29-40
ISSN: 2150-3338 (print)
ISSN: 2156-8081 (online)

www.theIBFR.com

ACCOUNTING FOR LEASES: UNDERSTANDING THE IMPACT OF ASC 842, LEASES

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CASE DESCRIPTION

The case seeks to contrast the lease accounting under the previous standard (ASC 840) and the guidance to be implemented in 2019 (ASC 842). The case is relevant for accounting majors especially those taking Intermediate Financial Accounting II. It is also relevant for business and finance majors dealing with corporate financial statements. It is also useful for professionals in practice/industry interested in how the new rules will affect their company. In the context of a hypothetical CFO and finance function of a domestic airline company, the case requires the performance of a web search and the procurement of information on former and current lease accounting. The case also requires the write-up of responses to questions comparing and contrasting the old and new guidance under ASC 840 and ASC 842, respectively; and, the creation of Right-of-Use Asset ("ROUA") and lease amortization schedules. The paper is suitable for undergraduate classes. Individuals or groups may be required to simply write-up their answers to the questions posed or present their research to the class for discussion and comment, especially with regard to the last, optional question. Completion of the case should require 5-10 hours outside of class. Classroom discussion should be about two hours.

JEL: M41, M42

KEYWORDS: Lease Accounting, Accounting Standards Codification (ASC) 842, International Financial Reporting Standards (IFRS) 16, Airline Industry**,** Off-Balance Sheet Financing

CASE INFORMATION

Historically Problematic Nature of Lease Accounting

The accounting for leases has posed problems for decades. Since at least the late 1940s, accounting standard-setters have wrestled with the issues relating to lease accounting. In 1976, after more than 25 years of increasing pressure from users and the leasing industry, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") 13, Accounting for Leases. SFAS 13 became the much-amended basis of ASC 840 in the Accounting Standards Codification at its inception in 2009. The standard aimed to capitalize long-term financing leases on lessees' books, provided they met at least one or more of four very specific rules or tests.

The FASB amended SFAS 13 numerous times; the net effect of which became the now superseded ASC 840 – Leases. However, this failed to stem the tide of off-balance sheet ("OBS") financing because lessees managed to avoid the bright-line thresholds that undergirded the four, "bright line" rules or tests for whether a lease should be capitalized. The "bright line" rules or tests required on-balance sheet capitalization and recognition of the often-enormous lease assets and liabilities. How did lessees manage to avoid capitalizing leases? They found loopholes! Thus, lease accounting ultimately has the dubious honor of being the most frequently amended financial accounting standard. As a result, lease accounting is frequently adduced as "Patient Zero" evidence of the failure of rule-based or "bright line" thresholds in accounting standards and of the need for principle-based standard setting.

In February 2016, as part of a multi-decade joint effort at convergence in lease accounting, the Financial Accounting Standards Board issued ASC 842, "Leases.". The International Accounting Standards Board issued International Financial Reporting Standard 16, "Leases." This guidance supersedes the preceding guideline ASC 840. For most companies these changes will take effect on January 1, 2019 but will take effect for public companies on December 15, 2018. ASC 842 changes the guidelines on how lessees and lessors report assets and liabilities on their balance sheet. The most pertinent aspect of ASC 842 is determining whether it is a finance lease or an operating lease and subsequently following the rules for asset/liability recognition.

To recap: SFAS 13 was the original US GAAP pronouncement that was amended and re-interpreted numerous times. ASC 840 was the Codification of SFAS 13 (as amended) in 2009. SFAS 13/ASC 840 comprises the former ("bright line") way of accounting for leases under US GAAP. ASC 842 is the new/current, method of accounting for leases under US GAAP. It supersedes the SFAS 13/ASC840. IFRS 16 is the new/current version of international GAAP and a very close cousin of ASC 842. (See Question/Solution 10 for details on similarities and differences between ASC 842 and IFRS 16.)

<u>We Have to Do WHAT with Our Leases?</u>

The Company: Table 1 provides a brief description of key operational and leasing facts and circumstances of a hypothetical domestic airline company, BlueSky Airlines.

Table 1: Brief Description of the Key Operational and Leasing Facts and Circumstances of BlueSky Air

1	BlueSky Air is a United States domiciled airline company that began operations in 2019.
2	Due to being relatively new to the industry, BlueSky Air does not have the financial wherewithal to buy a sufficient number of planes to conduct the volume of activity necessary for it to meet its budgeted goals. Therefore, they lease ten (10) of their 15 planes from Columbia Financial, Inc.
3	BlueSky Air was able to keep costs low by using a bank and operating under a 10-year lease that ends December 31, 2029 with an option to buy at the end. BlueSky Air is looking to expand their fleet by leasing five more planes; however, it is concerned about how the adoption of ASC 842 is going to affect their balance sheet. Additionally, BlueSky Air is concerned with the transition of their current leases to the new accounting standards.

This table shows some of the key operational and leasing facts and circumstances of BlueSky Air.

The Chief Accounting Officer (CAO) needs to know what the impact on assets and liabilities will be upon adoption of ASC 842. Table 2 notes the lease accounting guidance the CAO requires on several issues:

Table 2: Lease Accounting Guidance the CAO Requires

1	Is there still a net benefit to leasing instead of purchasing the aircraft?
2	Is it more advantageous to use a finance lease instead of an operating lease?
3	How will these new rules affect reported assets, liabilities, earnings, and ratios vs. the old rules?

Table 2 displays the lease accounting guidance the CAO requires.

The CAO has asked a member of the accounting staff to report on the new ASC 842 guidelines in order to bring the staff up to date.

Lease Details: Table 3 details the significant lease provisions with which BlueSky and their accounting function will have to contend.

Table 3: Lease Details

1	The term of the lease is ten years. The planes have an expected economic life of 20 years.
2	The planes have a fair value at the inception of the lease of $54,554,859.79 **[this item can be omitted from the fact pattern]** with an unguaranteed residual value of $24,503,130.96.
3	The expected residual value is greater than the guaranteed residual value.
4	BlueSky Air has an incremental borrowing rate of 8%, but Columbia Financial Inc. sets their annual rental rate to earn a rate of return of 6% per year. BlueSky Air knows this rate.
5	The lease agreement is non-cancelable, requiring equal annual payments in the amount of $5,238,919.71 on January 1 of each year, for ten years, starting January 1, 2019.
6	BlueSky Air amortizes the right-of-use asset ("ROUA") on a straight-line basis.

Table 3 notes important details of the plane lease including its term, estimated economic life and the relevant discount rates, among other items.

QUESTIONS

1. Access one of the Big Four/Global Eight public accounting firms and obtain the firm's publication on ASC 842. You are only looking for an overview of the guidance. The CAO only wants an introduction to the guidance not detailed information. Attach a file to your report with this information or publication for review by the CAO.

2. Indicate the ASC standard followed by BlueSky Air prior to the adoption of ASC 842. (Use of the ASC is preferred but current pre-convergence guidance from an Intermediate Accounting text should suffice.) What is the number of the newly minted IFRS standard that corresponds to ASC 842?

3. Describe the main differences when accounting for leases between the prior standards (ASC 840) and the standards to be implemented (ASC 842).

4. What are the lease classification tests for differentiating between a Finance lease and an Operating lease? Perform a lease classification test for the lease agreement described above.

5. Verify the calculation of the present value of lease payments for one of BlueSky Air's planes to determine the capitalized amount/ lease liability. (Use Columbia Financial's implicit rate of return.)

6. Create a Lease Amortization Schedule and a Right-of-Use Asset Amortization Schedule using the effective-interest method for one of BlueSky Air's leases.

7. Prepare journal entries on the books of BlueSky Air, as of January 1, 2019, for recording one of the leases and the first lease payment. Prepare the journal entry to record the lease expense, the increase in the lease liability and amortization of the ROUA as of December 31, 2019, on the books of BlueSky Air.

8. In your opinion, does the new method of accounting for leases provide a clearer picture of the company's financial position?

9. When using ASC 842, should the ASC 840 lease amounts be disclosed in a note to the financial statements or simply ignored?

Depending on the amount of time to be devoted to the case, the following step may be assigned.

1. Complete a review of four articles written by the Big Four discussing the pros and cons of the new standard. Specifically address the following issues:

   a. How will lessees recognize leases on the balance sheet? Address the lease liability initial value and subsequent measurement as well as the Right-of-Use Asset's initial value and subsequent measurement for finance and operating leases.

   b. What are the expanded quantitative and qualitative disclosures?

   c. What are the similarities and differences between the new lease accounting under US GAAP, ASC 842, as opposed to IFRS 16?

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TEACHING NOTES

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CASE DESCRIPTION

The case seeks to contrast the lease accounting under the previous standard (ASC 840) and the guidance to be implemented in 2019 (ASC 842). The case is relevant for accounting majors especially those taking Intermediate Financial Accounting II. It is also relevant for business and finance majors dealing with corporate financial statements. It is also useful for professionals in practice/industry interested in how the new rules will affect their company. In the context of a hypothetical CFO and finance function of a domestic airline company, the case requires the performance of a web search and the procurement of information on former and current lease accounting. The case also requires the write-up of responses to questions comparing and contrasting the old and new guidance under ASC 840 and ASC 842, respectively; and, the creation of Right-of-Use Asset ("ROUA") and lease amortization schedules. The paper is suitable for undergraduate classes. Individuals or groups may be required to simply write-up their answers to the questions posed or present their research to the class for discussion and comment, especially with regard to the last, optional question. Completion of the case should require 5-10 hours outside of class. Classroom discussion should be about two hours.

GENERAL COMMENTS

This case is designed to be used in an Intermediate Financial Accounting class. However, with slight modification, it might be useful to finance classes on financial statement analysis, a senior strategic management class, or an MBA financial management or financial reporting course. The case was developed for use in a country that uses US GAAP and the Accounting Standards Codification (ASC). However, the IASB and FASB standards are being developed in concert are thus very similar. Thus, the case can be modified to reflect IASB guidance. This case is not designed for students to understand the intricacies of lease accounting, but rather as an introductory look at the new process for, and basics of, lease accounting. Any changes to the standards will more likely than not change the approach under ASC 842 and the case would need to be modified appropriately.

SOLUTIONS

Question 1: Access one of the Big Four/Global Eight public accounting firms and obtain the firm's publication on ASC 842. You are only looking for an overview of the guidance. The CAO only wants an introduction to the guidance not detailed information. Attach a file to your report with this information or publication for review by the CAO.

Solution 1: This step in the case allows the user to see that there are many sources of information about the IASB and FASB guidance.

Table 1: Listing of Relevant Publications Related to ASC 842 – Leases from Each of the Big Four Websites and Links to the Remainder of the "Global Eight"

a	PWC:https://www.pwc.com/us/en/cfodirect/publications/accounting-guides/pwc-lease-accounting-guide-asc-842.html. This link (PricewaterhouseCoopers, 2018) brings the user to the PWC site and gives them an option to download a guide or watch a video series.
b	Deloitte: https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-applying-the-new-leasing-standard.html. This link (Deloitte, 2019) brings the user to the Deloitte site that has both detailed guidance and summarized lease accounting guidance. There are also highlights for different aspects of the lease accounting process towards the bottom of the page (see also Deloitte, 2016).
c	KPMG: https://frv.kpmg.us/content/dam/frv/en/pdfs/2017/kpmg-handbook-leases.pdf. This link (KPMG, 2017a) brings the user to a KPMG guide on the effect of the new standard on corporations. This link brings the user to the leasing rules and analysis under ASC 842.
d	EY: https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2/$file/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2.pdf This link (Ernst & Young, 2019) brings the user to the EY site and a downloadable guide on ASC 842..
e	The following link to several of remaining Global Ten professional accounting firms. Students can research their perspectives at their web sites. Some additional links are included in the References section.
	1 Grant Thornton: https://www.grantthornton.com/; Kratzke and Cherwin, 2016
	2 BDO: https://www.bdo.com/; BDO, 2018; BDO, 2019
	3 RSM McGladrey: https://rsmus.com/what-we-do/services/assurance/featured-topics/lease-accounting-842.html (RSM, 2019)
	4 Baker Tilley: https://www.bakertilly.com/; https://www.bakertilly.com/specialties/asc-842-lease-accounting (Baker Tilly, 2019)

Table 1 provides a listing of relevant publications related to ASC 842 – Leases from each of the Big Four websites and the relevant websites of other large international public accounting firms.

Question 2: Indicate the ASC standard followed by BlueSky Air prior to the adoption of ASC 842. (Use of the ASC is preferred but current pre-convergence guidance from an Intermediate Accounting text should suffice.) What is the number of the newly minted IFRS standard that corresponds to ASC 842?

Solution 2: BlueSky previously followed ASC 840. The newly minted IFRS standard for leases is IFRS 16.

Question 3: Describe the main differences when accounting for leases between the prior standards (ASC 840) and the standards to be implemented (ASC 842).

Solution 3: The main differences between ASC 840 and ASC 842 are the recognition of assets and recording of liabilities for lessees *on* the balance sheet especially with regard to operating leases.
Table 2 provides a summary of new lease accounting rules.

Table 2: Summary of New Lease Accounting Guidance under ASC 842

1	Lessees are required to recognize assets and liabilities for leases with lease terms of more than 12 months.
2	Leases will continue to be classified as a finance (formerly 'capital') or operating leases. However, BOTH finance AND operating leases will be recognized on the balance sheet.
3	Additional disclosures of a quantitative and qualitative nature to communicate better the amount, timing, and uncertainty of cash flows arising from leases are required.
4	Lessor accounting is largely unchanged. Improvements align lessor and lessee accounting consistent with the updated revenue recognition rules issued in 2014.
5	Impact on Financial Reporting:
	a Capitalizing leases will have a significant impact on recognition of assets and liabilities on the balance sheet for a wide variety of companies. This will change balance sheets, net income, and various ratios but will NOT affect cash flows. There will be increases in EBITDA, Total Assets, Total Liabilities and Leverage ratios. There will be decreases (increases) in EPS in earlier (later) years, Net Assets, and Interest Coverage and Asset Turnover ratios.
	b Financial Management (Rowe, 2017) estimated that companies listed on major stock exchanges have a combined $3 trillion in leasing commitments over 85 percent of which are not reported on the companies' balance sheets under ASC840. Due to differing financing structures, risk to the system is heightened via a lack of transparency and of comparability.
	c It is anticipated that the industries where this will have the biggest impact on companies' income before taxes are retail, telecommunications, information technology, transportation, construction, and agriculture. However, any company that has lease agreements will be affected.

This table provides a listing of some of the key elements of the accounting rules under the recently implemented ASC 842. (See KPMG, 2017a; KPMG, 2018a; KPMG, 2018b).

Question 4: What are the lease classification tests for differentiating between a Finance lease and an Operating lease? Perform a lease classification test for the lease agreement described above.

Solution 4: The lease classification tests for differentiating between a Finance lease and an Operating lease are listed on p. 339 of KPMG, 2017a.

If the answer to any one of the questions at the citation above is "yes"/if any of the lease characteristics listed above applies, the lessee classifies the lease as a finance lease. If the answer to ALL one of the questions is "no"/if none of the lease characteristics listed above applies, the lessee classifies the lease as an operating lease. Table 3 analyzes the BlueSky lease against the classification tests under ASC 842.

Table 3: Analysis of Lease Classification Tests Applied to BlueSky

1	Transfer of ownership test: The lease does *not* transfer ownership to BlueSky Air.
2	Purchase option test: Columbia Financial does *not* allow for an option to purchase the asset that BlueSky Air is reasonably certain to exercise.
3	Lease term test: The lease term is half the asset's (10 out of 20 years) economic life. This does *not* meet the general threshold of 75% of the estimated economic life of the leased asset for classification as a finance lease.
4	Present value test: The lease does *not* pass the present value test because the present value of the sum of the lease payments does *not* equal or exceed substantially all of the underlying asset's fair value (using the 90% threshold). Note: the lessee residual value is unguaranteed and therefore not included in the present value computation for purposes of lease classification.
5	Alternative use test: Because the asset could potentially be leased out to a different airline following the life of the lease, it does *not* meet the "no alternative use" test.
	Based on the above information, the lease does not meet any of the finance lease classification criteria. Therefore, it would be classified as an operating lease.

This table analyzes the BlueSky plane lease against the classification criteria of ASC 842. It concludes the lease does not meet any of the finance lease classification criteria and that it would be classified as an operating lease.

Question 5: Verify the calculation of the present value of lease payments for one of BlueSky Air's planes to determine the capitalized amount/ lease liability. (Use Columbia Financial's implicit rate of return.)

Solution 5: See Table 4

Table 4: Calculation of the Present Value of Lease Payments to Determine Capitalized Amount and Lease Liability

N	I	PV	PMT	PV
10	6%	54,554,860	(5,238,920)	(24,503,131)
Date	**Annual Payment**	**Interest (6%) on Liability**	**Reduction of Lease Liability**	**Capitalized Amount/Lease Liability**
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
1/1/2024	5,238,920	2,360,519	2,878,401	36,463,575
1/1/2025	5,238,920	2,187,814	3,051,105	33,412,470
1/1/2026	5,238,920	2,004,748	3,234,172	30,178,298
1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131

This table shows that the capitalized amount/lease liability are $24,503,131.

Question 6: Create a Lease Amortization Schedule and a Right-of-Use Asset Amortization Schedule using the effective-interest method for one of BlueSky Air's leases.

Solution 6: See Table 5 and Table 6

Table 5: Lease Liability

Date	Annual Payment	Interest (6%) on Liability	Reduction of Lease Liability	Capitalized Amount/Lease Liability
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
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1/1/2026	5,238,920	2,004,748	3,234,172	30,178,298
1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131

Table 6: Right-of-Use Asset Amortization Schedules

Date	Lease Expense (Straight Line)	Interest (6%) on Liability	Amortization of Right-of-Use Asset (ROUA)	Carrying Value of (ROUA)
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
1/1/2024	5,238,920	2,360,519	2,878,401	36,463,575
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1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131

These tables show the amortization patters for the lease liability and Right-of-Use Asset under the BlueSky plane lease.

Question 7: Prepare journal entries on the books of BlueSky Air, as of January 1, 2019, for recording one of the leases and the first lease payment. Prepare the journal entry to record the lease expense, the increase in the lease liability and amortization of the ROUA as of December 31, 2019, on the books of BlueSky Air.

Solution 7: The entries are as follows:

	1/1/2019	
Right-of-Use Asset	54,554,860	
Lease Liability		54,554,860

To record Right-of Use Asset and related lease liability at inception of lease. See calculation of present value of lease payments.

Lease Expense	5,238,920	
Cash		5,238,920

To record initial rent payment on lease aircraft

	12/31/2019	
Lease Expense	5,238,920	
Lease Liability		2,958,956
Right-of-Use Asset		2,279,963

To record interest component and amortization component Right-of-Use Asset (These are separate under IFRS)

Question 8: In your opinion, does the new method of accounting for leases provide a clearer picture of the company's financial position?

Answer 8: Students may have a variety of answers. The answer with the most support should be one that says the substance of the company's financial position as a result of the leasing transactions it has entered into is more clearly conveyed under the new lease accounting guidance of ASC 842.

The new lease accounting rules were created via an exhaustive process commencing in 2006 at the request of investors, regulators, ratings agencies, and other financial statement users for more faithful representation of the substance of leasing activities, and reflect their input in the form of numerous drafts exposed for comment and hundreds of comments. Specifically, critics of ASC 840 lease accounting viewed the off-balance sheet motivation and element of lessee lease accounting to be an egregious failure to capture the substance of long-term leasing transactions. To that end, the new lease accounting rules end the widespread practice of conforming to bright-line rules for capitalizing in form but not in substance. Now, companies will be required to recognize assets and liabilities associated with nearly all lease activities (there are exceptions of short term and low dollar value leases).

In addition, similar to many recent pronouncements by accounting rule-makers, disclosure of leasing transactions have been greatly enhanced, requiring more qualitative and quantitative disclosures which should better inform financial statement users and assist them in better assessing the amount, timing and uncertainty of future cash flows arising from leasing transactions.

Question 9: When using ASC 842, should the ASC 840 lease amounts be disclosed in a note to the financial statements or simply ignored?

Answer 9: Per KPMG, 2019, "Lessees have a choice of adopting ASC 842 by restating comparatives (comparative method) or without restating comparatives (effective date method)." In the comparative method, prior period amounts are restated to conform to ASC 842. Under the effective date method, prior period amounts are not restated.

The following step may or may not be assigned depending on the amount of time desired.

Question 10: Complete a review of four articles written by the Big Four discussing the pros and cons of the new standard. Specifically address the following issues:

> a-How will lessees recognize leases on the balance sheet? Address the lease liability initial value and subsequent measurement as well as the Right-of-Use Asset's initial value and subsequent measurement for finance and operating leases.
>
> b-What are the expanded quantitative and qualitative disclosures?
>
> c-What are the similarities and differences between the new lease accounting under US GAAP, ASC 842, as opposed to IFRS 16?

Solution 10: Answers will vary based on the resources accessed. The References lists typical sources. References such as KPMG, 2016; KPMG, 2017a; KPMG, 2018a; and KPMG, 2018b, respectively, will be useful to the Instructor for responding to items a and b, above. Item c responses should incorporate the US GAAP/IFRS similarities and differences identified in KPMG, 2017b, KPMG, 2018c, and PricewaterhouseCoopers, 2018b, respectively.

ACKNOWLEDGMENTS

The authors gratefully acknowledge the research assistance provided by Austin Roney, MBA student at SUNY Polytechnic Institute, Utica.

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