

San Jose State University

Mini Case 1

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March 12, 2018

Question 1 (20 points):

In class, we are covering the accounting for leases under new accounting standards. Find and interpret the standards under the new GAAP and the old GAAP.

According to GAAP, a lease agreement is contractually binding, and includes an owner or lessor and a user or lessee. Under the old GAAP methodology, only particular lease agreements were recorded on the balance sheet. Such leases were considered capitalized lease agreements and follow four criteria to be considered such (ASC 840-10-25-1). The original guidelines were very specific, reducing the number of lessees that considered their agreements as rights of ownership. The old method was highly deceptive and only helped make a lessee's balance sheets appear more appealing, since liabilities were not accounted for. Currently, the only leases included on the balance sheet are non-operating leases, that is, leases that transfer ownership of the asset to the user (ASC 840-30-25-1).

Now, according to new GAAP, all and any lease agreements must be classified on a company's balance sheet, regardless of its nature. Accordingly, both finance leases and operating leases will be included on the balance sheet of lessees, as long as the lease agreement is longer than one year. The purpose is to realize economic ownership of an asset and liability that belongs to each party of the agreement, and to transfer set ownership to the correct party (ASC 842-10-25-2 & 842-10-15-4). The new standards require any of five criteria to be met, which include all the original four criteria for capital leases. However, the new criteria are now more general and potentially unclear (ASC 842-10-25-2). One positive, new addition is whether the asset is of specialized nature, and if it is, the lessee will recognize ownership. Conceptually, the criteria will require businesses to add ownership of assets where it is due, the balance sheet. In turn, businesses will also have to add lease liabilities to their balance sheets, and amortization to the income statement will remain (ASC 842-20-25-1 & 842-20-25-5). In consideration of changes though, the accounting methods concerning journal entries and such, will remain nearly untouched. However, with respect to the balance sheet, accounting recognition will be enhanced by presenting additional information concerning all lease types. In summary, the main goal of new GAAP lease identification is to increase the amount of ownership transfer recognized under lease agreements.

In our opinion, the new GAAP procedures are beneficial for investors, but can be proved unfavorable for businesses. The benefits realized by investors are formed from responsible, ethical accounting practice. Specifically, we have identified that investors now have information available to them that describes asset composition in more detail than before. This helps reinforce the accounting principle of full disclosure. Furthermore, companies will realize the possibility of negative results. For instance, consider a businesses' return on assets, ROA. The ROA measures how well a company receives a profitable return by use of its assets, and is computed as follows: net income divided by total assets. Thus, the more assets a business contains, the less its ROA, meaning potential loss of investor interest, as the business is not "responsibly" utilizing its assets. However, with more assets needing to be amortized, this may even out ROA, since amortization expense will be represented on the income statement. In summary, we believe that the new GAAP practice concerning leases will encourage full disclosure principles of accounting, and stimulate companies to think more responsibly about how its assets are composed. In turn, the new GAAP requirements will have a positive impact on financial statement structure. In conclusion, the new standards are proving somewhat unclear in nature and will require the good judgement of accountants. Time will determine whether these new standards will be represented as clearly as expected, for the companies they are intended for.

Additional references: (ASC 842-10-65-1)

Question 2 (20 points):

In class, we have discussed at length how companies account for various current assets and liabilities. Upon graduation, you decide to go work for a gigantic recording studio down in Los Angeles. However, upon arriving, you are thrust into a world with entirely different terms than what you're used to, such as royalties, licenses, record masters and a host of other things. Give a brief discussion of the main issues involved in accounting for this type and then how they should be accounted for.

ASC 928-605-25-1 License Agreements

Substantial revenues may be realized by the owner of a record master or music copyright by entering into license agreements. A license agreement may be, in substance, an outright sale.

ASC 928-605-25-2 License Agreements

The earnings process is complete and the licensing fee shall be reported by the licensor as revenue if both of the following criteria are met:

- a. Collectibility of the full fee is reasonably assured.
- b. The licensor meets all of the following conditions:
 - 1. Signed a noncancelable contract
 - 2. Agreed to a fixed fee
 - 3. Delivered the rights to the licensee who is free to exercise them
 - 4. Has no remaining significant obligations to furnish music or records.

ASC 928-605-25-3 Other Fees Paid

Other fees (for example, for free records distributed by a record club in excess of a stipulated number) also may be required under the license agreement. Such other fees that are not fixed in amount prior to the expiration date of the agreement shall be recognized as revenue by the licensor only when reasonable estimates of such amounts can be made or the agreement has expired.

ASC 928-430-25-1 Minimum Guarantees Paid

A minimum guarantee may be paid in advance by a licensee to a licensor. The licensor shall report such a minimum guarantee as a liability initially and recognize the guarantee as revenue as the license fee is earned under the agreement. If the licensor cannot otherwise determine the amount of the license fee earned, the guarantee shall be recognized as revenue equally over the remaining performance period, which is generally the period covered by the license agreement.

Our recording studio will enter into license agreements with other companies and recognize the licensing fee as revenue. Our company can only recognize revenue when the criterias are met. Before signing an agreement, we'll ensure that the other company has the ability to pay the full fee. Then, we'll proceed to signing a noncancelable contract, agreeing to a fixed fee, delivering the rights to the licensee, and making sure that there are no more obligations left in the contract. Then the process of recognizing licensing fees will be completed.

Under the license agreement, other fees may be required for other events. These fees that are not fixed in amount before the expiration date of the agreement can only be recognized as revenue if the agreement has expired or when reasonable estimates of such amounts can be made.

Our company will recognize any revenue earned in the transaction. During cases where there is variable consideration, the portion of the transaction price that depends on the outcome of future events, the transaction price would be estimated and recorded. Variable consideration will be estimated as the expected value or the most likely amount, depending on whichever method better estimates the amount our company will receive. If variable consideration is based on sales or usage of a license, those amounts are royalties and they will be included in the transaction price when the sales or usage has occurred. (Spiceland, Nelson, Thomas, 249)

ASC 928-340-25-1 Artist Compensation Costs—Advance Royalties

An advance royalty paid to an artist shall be reported as an asset if the past performance and current popularity of the artist to whom the advance is made provide a sound basis for estimating that the amount of the advance will be recoverable from future royalties to be earned by the artist.

ASC 928-720-25 Artist Compensation Cost—Royalties

The amount of royalties earned by artists, as adjusted for anticipated returns, shall be charged to expense of the period in which the sale of the record takes place. Advance royalties shall be charged to expense as subsequent royalties are earned by the artist. Any portion of such advances that subsequently appear not to be fully recoverable from future royalties to be earned by the artist shall be charged to expense during the period in which the loss becomes evident.

Our company will be able to pay advance royalties to artists who have previously proved to be successful, or is currently popular. We will estimate the amount of advance that will be recoverable from future royalties and will record it as an asset under royalty receivables. Later, the amount of royalty earned by artists will be charged to expense of the period in which the sale of the record took place. Any portion of the advances that are not recoverable will become a loss and will be recorded as an expense.

ASC 928-340-25-2 Record Master Costs

The portion of the record master cost borne by the record company shall be reported as an asset if the past performance and current popularity of the artist provides a sound basis for estimating that the cost will be recovered from future sales.

ASC 928-720-26 **Record Master Costs**

The portion of the record master cost borne by the record company not reported as an asset in accordance with paragraph 928-340-25-2 shall be charged to expense.

Our company will report record master costs as assets if the artist was previously shown to be successful or is currently popular and we know the cost can be recovered from future sales. In other cases where the artist was previously unsuccessful, or in the end when the costs are not recoverable, then the record master cost will be charged to expense.

Question 3 (35 points):

Choose a topic covered in this course (either already covered or which we will cover) and find and interpret the appropriate section(s) in the codification. Interpretation here will be particularly important, as I expect to see more than simply what you could find in your textbook. For full credit, I expect to see the application of this topic to unique or special industries (for example, special guidance for leasing in the airline industry, or the estimation for liabilities in financial services firms).

Classification of the lease

Leases are classified can be viewed as either a financing lease or an operating lease. The accounting that is used pertains to the conditions of the lease contract, specifically the economic benefit of the lease terms.

ASC 842-10-25-1 **LEASE CLASSIFICATION**

All individual lease components should be classified at the commencement date by an entity. Moreover, Only if the contract is modified and the modification is not accounted as the separate contract with paragraph 842-10-25-8, the entity can reassess the lease classification. In addition, if there is a change to the lease terms or if the lessee updates information of whether the purchase option will be exercised, then the lease can be reassessed for classification.

Assessment:

A leases commencement date is the date that the underlying asset is available for use. Each lease is to be classified at this time and recognized as either a finance lease or an operating lease. The classification given to a specific lease will be retained throughout the life of the lease, unless some modification is made to the lease terms or the initial determination of the purchase option being exercised is updated. With the new accounting standards update, lease classifications recognize a “right-of-use asset” as well as a related lease liability that is reflected on the company’s balance sheet.

ASC 842-10-25-2 **Lease Classification**

A lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales-type lease when the lease meets any of the following criteria at lease commencement:

- a. The underlying asset transfers ownership by the end of the lease terms.

- b. A purchase option is available for the lessee, and it is reasonably certain to be exercised.
- c. The terms of the lease are for a “major part” of the economic life of the underlying asset. It is generally accepted that if 75% or more of an asset’s economic life is being used under the lease terms, then it is considered a major part.
- d. The fair value of the underlying asset is equal to 90% or more of all the lease payments and residual value that is not reflected in the lease payments. “Substantially all” is generally considered to be 90% or more of the value of an asset.
- e. There is no alternative use of an asset for a lessor after the end of the lease terms because the asset is so specialized.

Assessment:

According to current GAAP, a lease is considered a financing lease for a lessee and a sales-type lease for a lessor if it meets one of the five criteria referenced above. If the lease transaction does not meet any of the criteria then it is considered an operating lease for the lessee. Furthermore, the lessor would view the lease as a direct financing lease if both of the following conditions are met: the present value of the sum of all lease payments plus any residual value guarantee are greater than or equal to the fair value of the asset, and it is probable that the lessor will collect the lease payments plus any amount needed to satisfy the residual value guarantee. If these two criterias are not met by the lessor, then the lessor will view the lease as a operating lease.

Finance Lease

Similar to legacy accounting for capital leases, a lessee in a finance lease initially records an asset and liability for the present value of the lease payments. Under ASC Topic 842, the asset is referred to as a right-of-use (ROU) asset. It represents the lessee’s right to use an asset over the term of the lease. The ROU asset and lease liability are recognized at lease commencement, the date on which the lessor makes an underlying asset available for use by the lessee.

Operating Lease

Unlike the lessee’s accounting for finance leases, the accounting for operating leases is quite different under the new lease accounting standard. In contrast to legacy accounting requirements, ASC Topic 842 requires lessees to recognize an ROU asset and lease liability for operating leases. At lease commencement, the lessee records exactly the same initial journal entry recorded under a finance lease.

ASC 842-25-14

If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in paragraph 842-20-30-5 to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

ASC 842-10-65

An entity need not reassess the lease classification for any expired or existing leases (for example, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).

ASC 842-10-25-3

The lease-term criterion in paragraph 840-10-25-1(c) addresses the lease term. The existence of a fiscal funding clause in a lease agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise of the fiscal funding clause is assessed as being remote, a lease agreement containing such a clause shall be considered a noncancelable lease; otherwise, the lease shall be considered cancelable and thus classified as an operating lease.

Industry Application: Airline Industry and Sale-Leaseback Transactions

An industry that needs specific guidance for lease accounting is the airline industry. Many of the assets that are used by airline companies are considered to be specialized, and usually do not have any use for the lessor after the life of the lease. Sale and leaseback transactions specifically are conducted by airline companies to reduce costs and maintain leverage on a long-term lease. The airline companies who conduct these types of transactions hope to recognize lower effective rates of interest on their long-term debt leases. Another positive affect for the airline companies is the quick generation of cash through the sale and leaseback transactions. In short, if there is an airplane or related asset owned by an airline company they can sell it to another company and immediately lease it back for use. Sale and leaseback transactions are popular courses of action to raise funds through owned assets. In turn, this can provide immediate economic relief to an airline company that faces high operational expenses. Moreover, this tactic also assists a company in promoting their stance against the high costs of financing long-term debt. Countless companies from all over the world utilize these types of transactions to obtain an upper-hand on the competition

(ASC 842-40-25-4) SALE AND LEASEBACK TRANSACTIONS

If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

- a. The seller-lessee shall:
 - 1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27
 - 2. Derecognize the carrying amount of the underlying asset
 - 3. Account for the lease in accordance with Subtopic 842-20.
- b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

Assessment:

In a sale-leaseback transaction, the lessee or original seller of the asset receive cash from the sale of the asset and then pays periodic payments to the lessor in order to retain use of the asset. The procedures for sale-leaseback transactions is closely related to the accounting done for finance and operating leases. The important difference is the cash received or lost on the sale of the asset must be reported in the books as a gain or loss. As referenced before, IndiGo is a powerful user of this type of lease transaction and have stated that they usually receive about \$4.5 million gain on each sale-leaseback transaction.