

Telephone Services Contract With Equipment Included in the Lease

**Disclaimer – The exposure draft received nearly 700 letters of comment through the comment period ended December 15, 2010. There is some expectation that key features of the standard will be modified as a result of constituent response. As a result, these illustrative examples will not likely be accurate or appropriate to rely upon after issuance of the final standard. We have provided these as an educational tool only and do not represent these examples to be accurate under current or future final standards. Any templates used in the examples below are for internal use only and are not available for distribution.

Leasing Example – Telephone Services Contract with telephones and computer equipment included in the lease

Subject:

ABC Corporation has entered into a service contract for a new telephone system. As part of the lease, the Company will also lease certain telephone and computer equipment from the same vendor supplying the service contract.

Details:

The Contract/Lease terms are as follows:

Lessee:	ABC Corporation (ABC)
Lessor:	Telephone Support Technology, LLC (TST, LLC)
Equipment provided for in contract:	50 telephones and operating software to support system
Term:	5 years
Contract Date	November 30, 2009
Commencement Date:	January 1, 2010
Monthly cost/lease:	\$10,000 per month; stated at 25% for service contract fees and 75% equipment/software cost in the contract from TST, LLC
Initial Direct Costs	ABC Corporation paid its attorney \$2,500 in conjunction with the lease process
Security Deposit:	\$25,000
Free Rent Period:	No free rent or service periods were provided for
Option to Extend:	Contract may be extended for one (1) additional term of five (5) years (for service contract only at \$3,000 per month)
Subletting:	Not permitted
Residual Value Guarantees:	None
Purchase Option	At the end of the 5 year equipment/software lease both can be purchased for fair market value

Other relevant assumptions:

Incremental borrowing:	The incremental borrowing rate of ABC Corporation is 6%
Rate charged by Lessor	This rate cannot be reliably determined by the lessee
Likelihood of extension:	100% certain (no probability weighting)
Reassessment:	None
Amortization:	The Right to Use Asset will be amortized straight line over the life of the lease (5 years, exclusive of extension period since that is only for an extension of the service contract)
Service Contract Expense:	The service contract component is distinct and the cost specified in the contract (\$2500 per month for first five years and \$3000 per month for second five years) is appropriate in accordance with the FASB exposure draft on revenue from contracts with customers. The

service contract cost will be expensed each period as incurred (\$30,000 per year 2010-2014, \$36,000 per year 2015-2019) and is not reflected in the calculations and entries below.

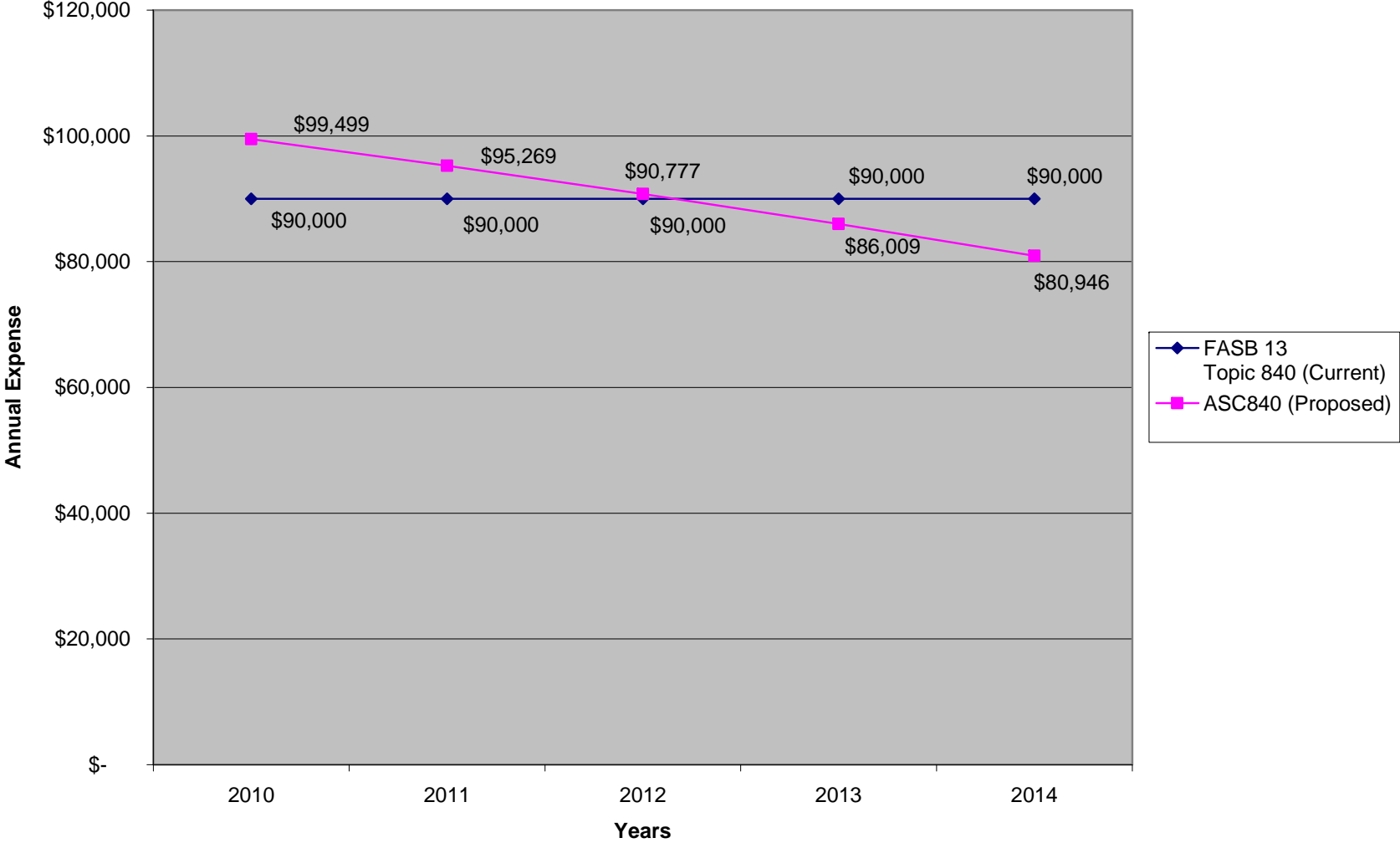
Comparison of Financial Statement Impact for Life of the Lease

Detailed balance sheet comparisons follow, but the summary impact of key elements are listed below:

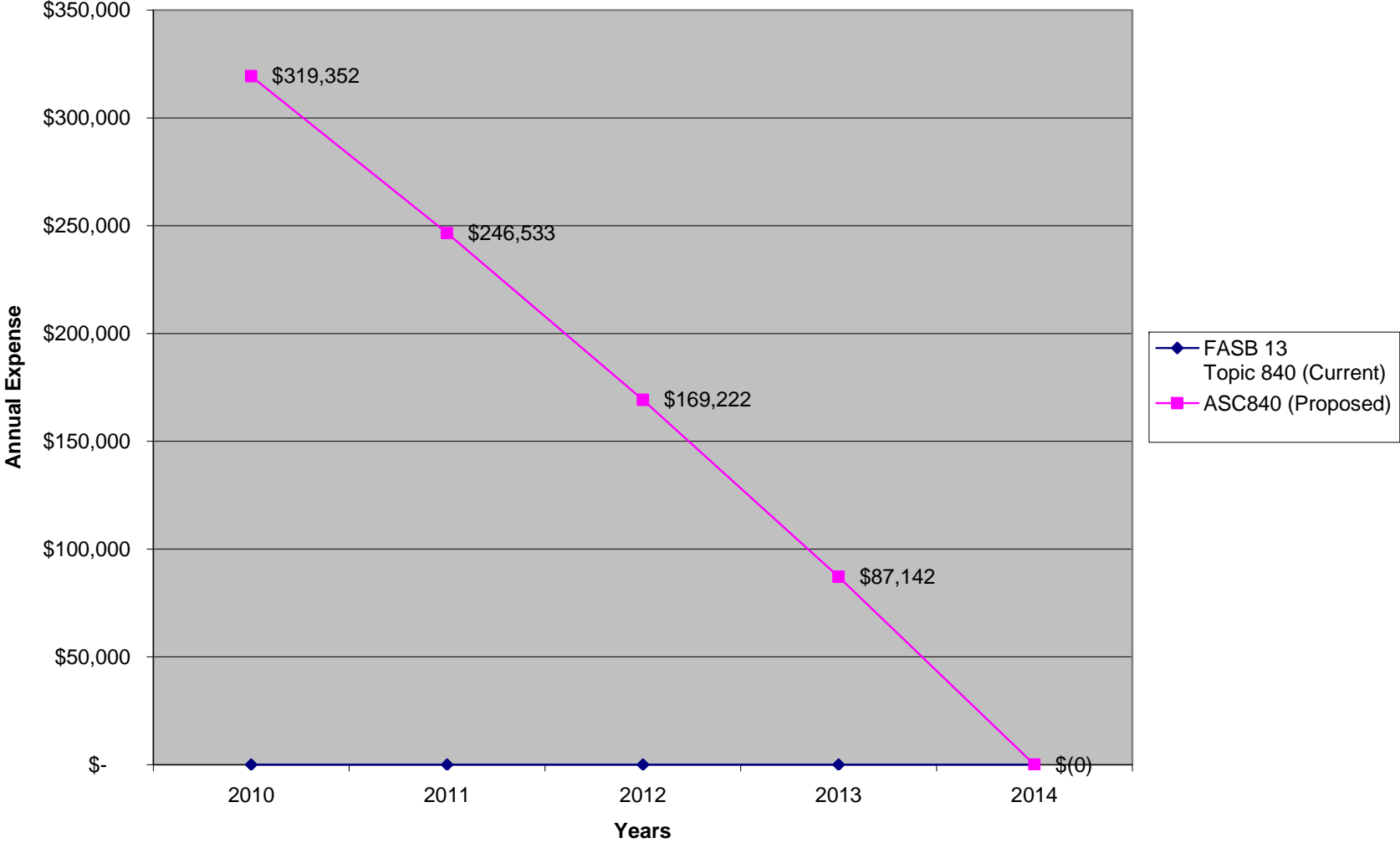
Year	Rent Expense vs. Amort / Interest		Security Deposit vs. Right To Use Asset		Straight Line Liab vs. Lease Liability	
	FASB 13 (Current)	ASC840 (Proposed)	FASB 13 (Current)	ASC840 (Proposed)	FASB 13 (Current)	ASC840 (Proposed)
2009	\$ 2,500	\$ -	\$ -	\$ 2,500	\$ -	\$ -
2010	\$90,000	\$99,499	\$25,000	\$ 312,353	\$ -	\$ 319,352
2011	\$90,000	\$95,269	\$25,000	\$ 234,265	\$ -	\$ 246,533
2012	\$90,000	\$90,777	\$25,000	\$ 156,177	\$ -	\$ 169,222
2013	\$90,000	\$86,009	\$25,000	\$ 78,088	\$ -	\$ 87,142
2014	\$90,000	\$90,946	\$25,000	\$ -	\$ -	\$ -
2015	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Totals	\$ 452,500	\$ 452,500				
Average Balance			\$25,000	\$ 156,177	\$ -	\$ 164,450

Note – The contract for the lease of the equipment and operating software is for five years. The equipment and software can be purchased for fair value at the end of the five years. In addition, the service contract can be renewed for an additional five years, but that is for service and not for the lease of the equipment and operating software. It is likely the equipment and software will be purchased and the end of the initial 5 years, but that does not factor into the above computations. The renewal or extension of the service contract does not impact the above computations either.

Impact on Net Income



Impact on Lease Liability



Comparison of Financial Statement Impact for Life of the Lease – Detailed by Year

December 31, 2010 – Initial Year End

	FASB 13 (Current)		ASC840 (ED - Proposed)	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
Income Statement				
Operating Expense (Rent)	\$ 90,000		\$ -	
Amortization Expense	\$--		\$ 78,088	
Interest Expense	\$--		\$ 21,411	
Impact on Net Income	\$ 90,000		\$ 99,499	
Balance Sheet				
<i>Assets</i>				
Security Deposit		\$ 25,000		\$ 25,000
Right to Use Asset		\$ -		\$ 390,442
Accm Amort – RTUAsset		\$ -		\$ (78,088)
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$ -		\$ (319,352)

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

December 31, 2012 – Middle of Lease Term Life

	FASB 13 (Current)		ASC840 (ED - Proposed)	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
Income Statement				
Operating Expense (Rent & CAM)	\$ 90,000		\$ -	
Amortization Expense	\$ -		\$ 78,088	
Interest Expense	\$ -		\$ 12,689	
Impact on Net Income	\$ 90,000		\$ 90,777	
Balance Sheet				
<i>Assets</i>				
Security Deposit		\$25,000		\$ 25,000
Right to Use Asset		\$ -		\$ 390,442
Accm Amort – RTUAsset		\$ -		\$ (234,265)
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$ -		\$ (169,222)

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

December 31, 2014 – End of Lease Term Life

	FASB 13 (Current)		ASC840 (ED - Proposed)	
	Income Stmt	Balance Sheet	Income Stmt	Balance Sheet
Income Statement				
Operating Expense (Rent & CAM)	\$ 90,000		\$ -	
Amortization Expense	\$ -		\$ 78,088	
Interest Expense	\$ -		\$ 2,858	
Impact on Net Income	\$ 90,000		\$ 80,946	
Balance Sheet				
<i>Assets</i>				
Security Deposit		\$ 25,000		\$ 25,000
Right to Use Asset		\$ -		\$ 390,442
Accm Amort – RTUAsset		\$ -		\$ (390,442)
<i>Liabilities</i>				
Lease Liability (St Line / Lease Ob)		\$ -		\$ -

- Note that cash impacts are the same under both sets of accounting.
- Note that cash flows from leasing under current standards are part of operating income on the cash flow statement, but are separate out as financing cash flows under the proposed standard.

Lessee Current Accounting – Original Lease Term

Lease life Cycle		FASB 13 (Current)			ASC840 (ED - Proposed)		
<i>Date</i>	<i>Activity</i>	<i>Accounts</i>	<i>Debit</i>	<i>Credit</i>	<i>Accounts</i>	<i>Debit</i>	<i>Credit</i>
11/30/09	Security Deposit	Lease Deposit Asset Cash	\$ 25,000	\$ 25,000	Lease Deposit Asset Cash	\$ 25,000	\$ 25,000
11/30/09	Attorney Fees	Legal expense Cash	\$ 2,500	\$ 2,500	Right to Use Asset (RTU) Cash	\$ 2,500	\$ 2,500
1/1/10	Recognition of Right to Use Asset and Liability	None			Right to Use Asset (RTU) Lease Liability	\$ 387,942	\$ 387,942
2010	Monthly Expenses	Lease Expenses Cash	\$ 7,500	\$ 7,500	Avg Mthly Lease Interest Exp Lease Liability RTU Amortization RTU Accm Amort Cash	\$ 1,784 \$ 5,716 \$ 6,507	\$ 6,507 \$ 7,500
2011	Monthly Expenses	Lease Expenses Cash	\$ 7,500	\$ 7,500	Avg Mthly Lease Interest Exp RTU Amortization Lease Liability RTU Accm Amort Cash	\$ 1,432 \$ 6,507 \$ 6,068	\$ 6,507 \$ 7,500
2012	Monthly Expenses	Lease Expenses Cash	\$ 7,500	\$ 7,500	Avg Mthly Lease Interest Exp RTU Amortization Lease Liability RTU Accm Amort Cash	\$ 1,057 \$ 6,507 \$ 6,443	\$ 6,507 \$ 7,500
2013	Monthly Expenses	Lease Expenses Cash	\$ 7,500	\$ 7,500	Avg Mthly Lease Interest Exp RTU Amortization Lease Liability RTU Accm Amort Cash	\$ 660 \$ 6,507 \$ 6,840	\$ 6,507 \$ 7,500
2014	Monthly Expenses	Lease Expenses Cash	\$ 7,500	\$ 7,500	Avg Mthly Lease Interest Exp RTU Amortization Lease Liability RTU Accm Amort Cash	\$ 238 \$ 6,509 \$ 7,262	\$ 6,509 \$ 7,500