

**ACCOUNTING FOR LEASES: A COMPARATIVE ANALYSIS OF U.S.
GAAP AND IFRS**

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ABSTRACT

The expansion of the accounting standards, accounting for leases has created a constant debate since the authoritative difference in literature between U.S. GAAP and IFRS. Although, the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB) have been working jointly to eliminate differences between the two sets of standards, they pave the way toward the convergence of the U.S. generally accepted accounting principles (GAAP) with the international financial reporting standards (IFRS). In addition, despite their joint effort, there have been inconsistencies and criticism of the lease accounting. The aim of this study is to conduct a comparative analysis of U.S. GAAP and IFRS in regards to accounting for leases. Besides, this qualitative study explored the literature that covers the accounting for leases. The study presents a comparative analysis of leasing standards under U.S. GAAP and IFRS. The focus of the study is the accounting for the lessee.

Keywords: : IFRS 16, SFAS No. 13, IASB, Convergence, Accounting for Leases, Right-of-use, ASU-2016-2, Leasing

INTRODUCTION

According to the financial Accounting Standards Board (FASB), leasing is utilized by many entities. It is a means of gaining access to assets, of obtaining financing, and/or of reducing an entity's exposure to the full risks of asset ownership. The prevalence of leasing, therefore, means that it is important that users of financial statements have a complete and understandable picture of an entity's leasing activities (FASB, 2016). Harris and Sunna (2013) define a lease as a contract between the owner of an asset (the lessor) and another party (the lessee), whereby the lessee obtains the right to use the asset in exchange for periodic payments. Accounting for leases has created a constant debate since the expansion of U.S. accounting standards. Because of the

controversies posed by this topic, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have decided to join their effort to address this issue. In 2010, the boards issued a proposed Accounting Standards Update, *Leases (Topic 840)* to discuss the issue. However, because of the lack of consistency and transparency, a second proposed Accounting Standards Update, *Leases (Topic 842)* was released in May 2013. Despite the new Accounting Standards Update, the problems faced have not been resolved. In February 2016, another Proposed Accounting Standards Update (ASU) was issued. The authors of this article will use a qualitative research method to address some of the issues pertaining to current accounting for leases and the proposed changes to those standards.

Purpose of the Study

The purpose of this qualitative study is to explore the literature that covers the accounting for leases. The researchers will analyze the current and proposed leasing standards under the Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS). While the two accounting boards are working together to develop feasible and consistent standards for reporting leasing transactions on the financial statements, there are still controversies regarding current the leasing standards. This study will compare and contrast the accounting for leases under the two sets of standards. The focus of this study will be placed on the accounting for the lessee.

Problem Statement

Accounting for leases has always created a lot of controversies. According to Jeter (2006), current U.S. accounting standards allow for two different treatments on the financial statements: operating leases and capital leases. Spice land, Sepe, and Nelson (2013) describe an operating lease as a rental agreement in which the lessor retains the ownership rights and responsibilities whereas the lessee merely uses the asset temporarily. In an operating lease, the lessee does not include the asset on the balance sheet. The periodic rental payments are reflected on the income statement as operating expenses. On the other hand, in a capital lease, the risks and rewards of ownership are transferred from the lessor to the lessee. The lessee assumes responsibility of the asset and records it on the balance sheet as well as the corresponding liability.

Although operating lease is viewed as a short-term rental arrangement, many firms in many industries report very large non-cancelable operating lease commitments extending many years into the future. Corporate managers keep the leased assets and associated obligations off-balance sheet, and have found ways to record most leases as operating leases rather than capital

leases, to avoid new capitalization requirements set forth by the FASB. The current accounting standards for leases have been criticized for failing to meet the needs of users of financial statements because they often fail to provide a faithful representation of the leasing transactions. The most significant criticism of current standards on lease accounting is the opportunities it provides managers to manipulate financial statements and engage in off balance-sheet financing. According to the FASB, from 1980-2007, the amount of off-balance sheet lease financing as a percentage of total debt has risen 745%. In addition, a 2009 study by Price Water house Coopers of 3,000 companies indicated that interest bearing debt would increase 58% in 2008 if adjusted for off-balance sheet leasing activity. Due to the criticism, there was a great need to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities (FASB, 2016, p. 1).

Background of the Study

Since the development of U.S. accounting standards, lease accounting has been a controversial subject. Accounting organizations have attempted to revise the existing method for lease transactions since the early 1990's (Imhoff, Lipe, & Wright, 1997). According to Stickney and Weil (2007), "A lease is a contract calling for the lessee (user) to pay the lessor (owner) for use of an asset for a specified period of time" (p.791).

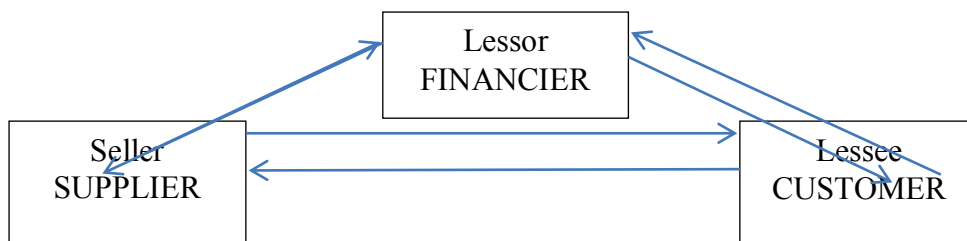
Under GAAP, lease accounting methods group leases into two categories: capital and operating. Whereas operating lease is viewed as a short-term rental arrangement, a capital lease is an agreement through which the lessor finances the acquisition of assets by the lessee (Schroeder, Clark, & Cathey, 2009). The Financial Statements Accounting Standards (SFAS) No.13 classifies a lease as capital lease if it meets some criteria. These criteria will be discussed later in this paper.

Capital leases are essentially treated like loans and require reporting on the balance sheet; while operating leases are basically handled like rent and contrarily are not reported as balance sheet items. Critiques argue that the present method for accounting for and reporting of leases leads managers and company executives to manipulate lease negotiations resulting in the creation and classification of operating leases where capital leases really should exist (Harris & Sunna, 2013). Under the proposed current developments and accounting standards, changes would be seen on the balance sheet, income statements, and profit ratios. More specifically, the current proposed method would treat all leases as an acquisition of a right to use the leased item for the lease term (Harris & Sunna, 2013). This accounting procedure would allow for similar handling of all leases regardless of the classification of capital or operating. Additionally, it would resolve all the criticism raised over the issues regarding lease accounting, in particular, the issue of difference in reporting on the balance sheet based on operating or capital leases.

With the above need for change, in 2010, the IASB and FASB joined forces to write the exposure draft for the standard change. Despite the proposed changes in the 2010 Exposure Draft, which resulted into ASU, *Leases (Topic 840)*, there was still a lack of consistency, transparency, and usefulness from the current standards. Later, in 2013, the boards introduced a new exposure draft that proposed the application of the right-of-use model for most leases (*Topic 842*). Under this model, the lessee would recognize assets and liabilities for leases with a maximum possible term of more than 12 months. In fact, the lessee would recognize a liability to make lease payments and a right-of-use asset representing its right to use the leased asset for the lease term (IFRS, 2013, para. 37). The lessee would then amortize the asset and incur interest on lease payments. Currently, lease payments are only reflected for operating leases in the period they occur. Therefore, the new standards would require an asset and liability to be recognized on the balance sheet at the time of contract (IFRS, 2013, para. 38). On the other hand, the lessor would recognize a lease receivable and derecognize the carrying amount of the underlying asset (IFRS, 2013, para. 68). Under the 2013 ASU (*Topic 842*), the lease assets and liabilities are required to be measured and reported at a discounted rate, providing useful information about future cash flows (IFRS, 2013, para. 41).

Theoretical framework of Financial Lease Contracts

Grenadier (1995) explained that a characteristic feature of leasing is separation of ownership and control of the leased asset with the lessee receiving the benefits of use and the lessor receiving the value of the lease payments plus the residual value of the asset. According to Tepora (1988), lease contract has a triple relation as showing the figure underneath.



1. The seller and the customer (lessee) negotiate about the object of the contract.
2. The seller makes an offer to the lessor concerning buying the object to be leased to the named customer. The offer includes approval of the offer from the customer.
3. When the lessor approves the offer, a sales contract between the lessor and the seller, and a leasing contract between the lessor and the lessee is made. The sales contract can also

include provisions about the seller buying the object back at the end of the lease period. Likewise the lease contract can contain provisions about the lessee having an option to buy the object at the end of the lease period.

4. The lessor orders the object to be delivered to the lessee.
5. The seller delivers the object to the lessee and sends the invoice to the lessor.
6. Typically the lessee pays the first lease payment when the invoice is due and the subsequent payments are due at the beginning of each lease period.
7. At the end of the lease contract the lessee returns the depreciated object to the lessor. If the sales contract between the lessor and the seller included a provision for buyback, it is exercised and the object is returned to the seller. Alternatively if the lease contract has an option for extending the lease period or acquire the depreciated object, the lessee can exercise these options.

Thus, in practice this separation is not, however, discrete, but there is a continuum of different types of lease contracts where the degree of control over the asset between the lessor and the lessee varies. In financial lease contracts, which this study is focusing at, the lessor has the ownership of the asset while the lessee has full control over leasing.

Key Differences between U.S. GAAP and IFRS in Accounting for Leases

Current Leasing Models

Deloitte (n.d) suggests that there are several differences between the U.S. GAAP and IFRS in regard to lease accounting both in the scope and the lease classification. Under GAAP, the scope is more limited. U.S. GAAP Accounting Standards Codification (ASC) 840 defines a lease as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. Conversely, under IFRS's, International Accounting Standard 17 (IAS 17) applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Therefore, the scope of IAS 17 includes the right to use other assets in addition to property, plant, and equipment (e.g., certain intangible assets). Intangible assets are within the scope of IAS 17 if rights are established for the exclusive use of such assets. For example, brands and trademarks often are licensed exclusively and therefore are intangible assets that are within the scope of IAS 17 (Deloitte, n.d).

As previously mentioned there are specific criteria that must be met with regard to the classification of leases. Accounting for leases under IFRS is rather subjective and adopts a principles-based approach; whereas under U.S. GAAP, the methods are much stricter utilizing a rules-based methodology. Deloitte (n.d) "Under U.S. GAAP, there are separate requirements for

sale-and-leaseback transactions involving real estate. ASC 840-40 contains criteria that must be met for the sale-and-leaseback transaction to be accounted for as a sale of real estate”(para, 2.).

Specifically, IAS 17 requires a lease to be classified as finance or capital lease when the following criteria are met (Harris & Sunna, 2013):

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable; at the inception of the lease; it is reasonably certain that the option will be exercised;
- The lease term is for the major part of the economic life of the asset, even if the title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- The leased assets are of a specialized nature, and only the lessee can use them without major modifications being made. Otherwise, the lease should be classified as an operating lease and omitted from the balance sheet under current standards; however it would be reported as a balance sheet item, on the income statement and included in ratio calculations under current proposed accounting standards (Harris & Sunna, (2013).

In comparison, ASC 840-10-25-1 requires the reporting of a capital lease under the following scenarios:

- Ownership of the leased asset transfers to the lessee at the end of the lease;
- The lease contains an option for the lessee to purchase the leased asset at a bargain purchase price;
- The lease term is 75 percent or more of the useful life of the leased asset; and
- The present value of lease payments is 90 percent or more of the fair value of the leased asset.

Otherwise, the lease should be classified as an operating lease and reported accordingly (Deloitte, n.d).The following chart provides visual representation of the balance sheet and income statement consequence for the lessee and the lessor under both GAAP and IFRS (Harris & Sunna, 2013).

Exhibit 1:

EXHIBIT 1 Balance Sheet and Income Consequences

The Lessee	Balance Sheet	Income Statement
Operating Lease	Off-balance-sheet item; not reported on the balance sheet.	The lessee records the lease payment as rent expense.
Finance Lease under IFRS (Capital Lease under U.S. GAAP)	The lessee reports the present value of the minimum lease payments as asset — part of property, plant, and equipment called leased asset. Additionally, a liability will be reported in this same amount called minimum lease obligation.	The lessee records the lease payment in two components: (1) interest expense and (2) depreciation expense.
The Lessor	Balance Sheet	Income Statement
Operating Lease	No effect. The asset is still reported on the balance sheet.	The lessor reports rent income equal to the lease payment received. Depreciation expense over the life of the asset is also reported.
Finance Lease under IFRS (Direct Financing Lease under U.S. GAAP). Sales Type Lease	The lessor has a sale of its asset and records a lease receivable.	The lessor reports a gain or loss on the sale of the asset. Interest revenue is recorded when the lessor collects the rent.
Finance Lease under IFRS (Direct Financing Lease under U.S. GAAP)	The lessor sells the leased asset, and records a lease receivable.	The lessor reports interest revenue when the lease amount is collected.

Adapted from: Harris, P., & Sunna, F. (2013). Lease accounting: History and Recommendations. *Internal Auditing*, 28(5), 37-41.

New Leasing Models

Leases are an important part of business structure. They allow access to physical and financial assets. They are an important tool in developing business structure and are used to decrease income, increasing tax assets by lowering liabilities while still providing capital benefits such as plant assets. However, despite the prevalence of leasing, much of this business activity is not reflected on the face of the financial statements. In 2005, the Securities Exchange Commission (SEC) estimated that \$1.25 trillion worth of undiscounted operating lease agreements were omitted from the balance sheet (FASB, 2013). In addition, accounting for leases is very inconsistent. This situation has caused many people to question the accounting methods for many reasons. First, the lack of consistency makes it difficult to identify objective criteria to draw a clear distinction between operating lease and finance lease (De Martino, 2011). As a result of this difficulty, the same transaction could have different accounting results because entities can interpret results to meet the needs of their business.

In order to facilitate the convergence of U.S. GAAP with IFRS, the boards have been working diligently to eliminate differences between GAAP and IFRS. To make the two sets of standards more in line, in January 2016, IASB issued IFRS 16, *Leases*. In this pronouncement, IASB lays out how both the lessee and the lessor are required to recognize, measure, present and

disclose leases. IFRS 16, *Leases* eliminates prior classification of leases as either operating lease or finance lease and replaces IAS 17. It introduced a single lessee accounting model in which the lessee is required to recognize a) assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value; and b) depreciation of lease assets separately from interest on lease liabilities in the income statement (IASB, 2016, p. 4). IFRS 16, *Leases* is consistent with the new standards proposed by FASB in ASU-2016-2. The new IFRS 16 is effective from January 1, 2019.

To eliminate differences between IFRS 16, *Leases* and current U.S. GAAP, in February 2016, FASB issued ASU-2016-2 (*Topic 842*). According to the FASB ASU-2016-2, previous leases accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there had been long-standing requests from many users of financial statements and others to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities. FASB also indicates that many of the criticisms associated with previous leases guidance related to the accounting for operating leases in the financial statements of lessees, and addressing those concerns with lessee accounting was the main focus of FASB and IASB. The FASB issued ASU-2016-2 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The FASB amended the Accounting Standards Codification and created Topic 842, *Leases*, to meet their objective (FASB, 2016, p. 1).

The main difference between previous GAAP and Topic 842 is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. Under the new guidance, a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. Consistent with current GAAP, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as finance or operating lease. However, unlike current GAAP, which requires only capital leases to be recognized on the balance sheet, the new ASU will require both types of leases to be recognized on the balance sheet.

For finance leases, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income

3. Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

For operating leases, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position

2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis

3. Classify all cash payments within operating activities in the statement of cash flows (FASB, 2016, p. 3).

For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term (FASB, 2016, p. 3).

The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements (FASB, 2016, p. 2). The ASU affects all companies and other organizations that lease assets such as real estate, airplanes, and manufacturing equipment. The ASU will require organizations that lease assets—referred to as “lessees”—to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. However, the accounting applied by a lessor remains mostly unchanged from that of the previous GAAP. For example, the vast majority of operating leases would remain classified as operating leases, and lessors would continue to recognize lease income for those leases on a generally straight-line basis over the lease term. The new ASU is effective after December 15, 2018 (FASB, 2016, p. 4).

Conclusion

The objective of this study was to conduct a comparative analysis of U.S. GAAP and IFRS in regards to accounting for leases. Generally, the joint IASB/FASB exposure drafts and the FASB ASU on accounting for leases will bring a significant improvement over the current model. Biondi et al. (2013) argue that “the proposed shift from an “ownership model” to a “right-of-use model” addresses many of the inconsistencies plaguing current standards. By eliminating bright line tests and removing the distinction between capital and operating leases, transparency in financial reporting will increase and greater consistency and comparability will be achieved (p. 2). The joint effort by FASB and IASB to eliminate differences and inconsistencies in the accounting for leases will significantly reduce off-balance sheet leases and

present a better picture of companies' financial position. This will also pave the road to the convergence.

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