LEASE ACCOUNTING: AN INVESTIGATION OF THE SUCCESS OF ACCOUNTING CONVERGENCE PROJECTS

by:

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Abstract

This paper explores the efforts of the United States Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to issue a converged accounting standard on leases. These boards represent the two major accounting standard setting entities in the world. With the support and encouragement of the United States Securities and Exchange Commission (U.S. SEC), the two boards have had the goal of working together to release a single set of converged accounting standards that would be accepted and used by listed (public) companies globally. The two boards began a joint project to converge lease accounting standards in the 1990's. They finally released their new, but not converged, standards in 2016. This paper delves into the process of convergence and looks into some of the potential issues that could have caused the eventual divergence of leasing standards between the FASB and IASB.

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Introduction

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) recently released new accounting standards on leases. These standards change significantly how companies, both lessees and lessors, recognize and measure leases on their financial statements. The topic of revising lease accounting was first considered in 1996, with the main goal of improving transparency and comparability in lease accounting. They expected to achieve this by capitalizing leased assets and the corresponding liabilities on the balance sheet, effectively eliminating off-balance sheet lease agreements (McGregor, 1996). Leasing standards had not changed for a long time while the number of lease agreements in which companies participate had increased dramatically.

Under previous FASB standards, a lessee accounted for a lease as either an operating or a capital lease. If a lease qualified as an operating lease, the lessee did not recognize the leased assets or the corresponding liability on its balance sheet. These leases became known as off-balance sheet leases. In a report in 2003 by The Securities and Exchange Commission (SEC), staff estimated that there were $1.25 trillion of off-balance operating lease commitments. These off balance sheet leases are a major analysis issue for users of the financial statements.

Convergence was become a hot topic for the FASB and the IASB. The goal of convergence is to improve comparability of financial statements on an international level. At the urging of the U.S. SEC, the FASB and IASB hoped to develop a single set of accounting standards that all listed (public) companies would apply (Garmong, 2012). Converged standards would improve comparability across companies in different countries around the world. Leases marked a major opportunity for the two boards to develop and release a converged set of standards. Many users of financial statements believed the old leasing standards were flawed and, by creating a single set of globally-applied standards, the two boards could take a major step towards this goal. The two boards spent many years trying to develop a joint set of standards. However, in 2014, admitting defeat, they decided to go their separate ways (Katz, 2015). The FASB and IASB could not come to an agreement on the accounting for leases so in early 2016, they each decided to separately released their own standard.

Hypothesis

Based on the results of their lease accounting project, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) achieved convergence.

Literature Review

Convergence- History and General Purpose

Convergence of accounting standards is not a new concept. The FASB website has a detailed timeline of convergence activities with all of the different events that occurred since the goal of harmonizing accounting standards arose in the 1950's. After World War II, people were concerned about achieving a degree of harmonization among accounting standards in the major international capital markets. This marked the first real discussion surrounding convergence. The next major step towards convergence was in 1970 with the formation of the International

Accounting Standards Committee (IASC). This committee was formed under the auspices of the International Federation of Accountants (IFAC), a global organization of national organizations of accountants. (The American Institute of Certified Public Accountants (AICPA) is an IFAC member.) The IASC's main objective was to develop a single set of globally accepted accounting principles. It hoped to achieve this by pulling together many different sets of standards and finding similarities between them. In 1993, the FASB and the IASC, together with the standard setting boards of, Canada, The United Kingdom, and Australia formed the G4+1 with the hope of improving and "harmonizing" their respective accounting standards. The IASC remained the international standard setter until 2001, when it was replaced by the IASB and the idea of a single set of international standards truly began to take hold.

In 2001, the IASB was formed to replace the IASC as the international standard-setter. In 2002, the FASB and IASB signed the Norwalk Agreement and started working together to converge United States Generally Accepted Accounting Standards (U.S. GAAP) and International Financial Reporting Standards (IFRS). In 2005, another major milestone towards having one set of accounting standards applied globally was achieved when the European Union (EU) adopted IFRS for EU listed companies (FASB, Comparability in International Accounting Standards: A Brief History). In 2007, the two Boards released their first major mostly converged standards on business combinations (FASB Website Timeline). The two boards also reached full or partial convergence on: borrowing costs (interest capitalization), discontinued operations, fair value measurement, segment reporting, and revenue recognition (Pacter, 2013). In 2007, U.S. SEC agreed to forego the required U.S. GAAP reconciliation of reported net income and shareowners' equity to US GAAP for foreign private issuers that applied "IFRS as issued by the IASB" in their financial statements.

There are still many issues with convergence. Many small US companies oppose convergence because they do not have the time or money to learn and implement new financial reporting standards. Many accountants in the U.S. also believe that U.S. GAAP is a higher quality alternative to IFRS because, in many cases, U.S. GAAP requires more precise measurement and reporting of financial statements.

Previous Lease Standards

Under the previous lease standards, there were two types of leases: operating and capital leases (called a finance lease in IFRS). A company could either recognize an operating lease or a capital lease. The accounting for operating and capital leases is very different. According to FASB ASC 840-10-25-1, a company would recognize a capital lease only if the lease agreement met one of the following criteria at the beginning of the lease:

1. “the agreement specified that ownership of the asset transfers to the lessee at the end of the lease term;
2. the agreement contained a bargain purchase option;
3. the lease term was equal to 75% or more of the expected economic life of the leased asset; or
4. the present value of minimum payments equaled or exceeded 90% of the leased asset’s fair value.”

If the lease met one of these criteria at the inception of the lease, the lessee would capitalize the leased asset and corresponding liability on its balance sheet. The lessee calculated interest expense using the effective interest method, which would result in a reduction of the liability for the difference between the expense and the lease payment. The lessee would also record depreciation expense on the leased asset. If the lease agreement did not meet any of the capital lease criteria, the lessee would use the accounting standards for an operating lease. They would not recognize the leased assets or the corresponding liabilities. Instead the lessee would record the lease payments as an operating expense (Cornaggia, 2013).

The major problem users had with this standard lies with the treatment of operating leases. The two types of leases are accounted for in significantly different ways even though they may be similar transactions. The classification is largely subjective and there are limited by “bright-line” tests that auditors and companies can perform to determine the classification of the lease. The lessee in an operating lease obtains the right to use the leased item, which meets the board’s definition of an asset. Lessees are also obligated to make rental payments, which meets the board’s definition of a liability, yet the lessee does not have to record an asset or a liability on the balance sheet (FASB/IASB, 2009, p. 14).

Lessees in operating leases are able to obtain a revenue generating item without having to record an asset or its corresponding liability. This can cause various performance metrics to test stronger than they actually are. In a research paper, Eric Bostwick looked at five companies and calculated key performance measures based on current financial statements and recalculated them after their financial statements were adjusted to capitalize leases on the balance sheet. Essentially, he wanted to see the effect on the financial statements if all operating leases were treated as capital leases. The key performance measures he looked at were, total debt to asset ratio (D/A), total debt to equity ratio (D/E), long-term debt to equity ratio (LTD/E), return on assets (ROA), and return on equity (ROE). Bostwick found that on average the D/A increased by 1.53%, the D/E increased by 5.23%, the LTD/E increased by 6.61%, the ROA decreased by 9.54% and the ROE decreased by 7.75% (Bostwick, 2013). Companies overall would have more debt on their balance sheet and their returns would be lower if they were forced to capitalize their leases. Bostwick was hoping to find what the effect of off-balance sheet leases have in the calculation of these performance metrics. His findings show the implications of these leases for external users of the financial statements. What kind of affect could their operating leases have on this metric and would investors reconsider if they had more accurate information? This research showed that under the current standards investors could be mislead by the information they are given. Companies with high numbers of operating leases tested much stronger than they should and their current numbers could be misleading.

Overview of Lease Convergence

Leases have been criticized for many years and in 1996 the G4+1 released their first research paper outlining their revised approach to the treatment of leases. They proposed to remove the two classifications of leases and move to a model that recognized a single type of lease. This type of lease would be treated similar to how we currently treat capital leases, where all assets and liabilities arising from the transaction would be recorded on the lessee's balance sheet (McGregor, 1996).

In 2000 the G4+1 released a second research paper, which went further into how the previously proposed standards would be implemented. The purpose of these research papers was to raise awareness of lease accounting issues and proposes a potential solution to solve the issues (Nailor, 2000). The purpose of these research papers was not to immediately change the leasing standards but to simply bring the issues to light and propose a potential solution.

In 2006 the FASB and IASB officially set out to converge lease standards. Their main goal was to improve financial reporting transparency by capitalizing more leases on the balance sheet. The boards hoped that they would be able to release a single set of international standards.

In 2009 the two boards released a joint discussion paper where they presented their preliminary views on leases and what they believed needed to be changed. The boards' first task was to identify the rights and obligations arising from lease agreements and determine if they met the definition of an asset and liability (IASB/FASB, 2009, p.26). In FASB Concept Paper 6, it states that an asset has the following characteristics:

1. "The entity controls an economic resource or benefit
2. It arises out of a past event
3. Future economic benefits are expected to flow to the entity"

They determine that the lessee controls the right to use the leased item during the lease term because the lessor does not have access to the item until the conclusion of the contract. The control arises out of the past signing of the lease contract and delivery of the item. The leased item is an economic resource for the lessee and it can be used to generate cash inflows during the lease term. The boards determined that the right to use a leased item fulfills all of the characteristics of an asset (IASB/FASB, 2009, p.26).

After the boards had determined that a lease fulfills the definition of an asset they had to do determine if a lease agreement also gave rise to a liability for the lessee. FASB Concept Paper 6 defines a liability as:

1. "There exists a present obligation of the entity
2. The obligation arises out of a past event
3. The obligation is expected to result in an outflow of economic benefits"

The board determined that the lessee has a present obligation to make the rental payments. This obligation arose from the past signing of the contract and delivery of the leased item. The obligation will result in outflows of economic benefits in the form of cash payments. The board determined that the obligation to make rental payments meets the definition of a liability (IASB/FASB, 2009, p.26).

After the board determined that a lease agreement created an asset and a liability for the lessee they began to develop their proposed model for lease transactions. Their preliminary model for lessees would treat all leases as an acquisition of a right of use asset. This means that the lessee must record an asset and a liability for the lease transaction. (IASB/FASB, 2009, p.30)

The purpose of releasing the discussion paper was for people to submit comments regarding the proposed changes. They receive comments from a wide variety of parties ranging from, company preparers to users to accounting firms all voicing their opinion on what is good and bad about the proposed changes. Roughly half of the responses on the discussion paper supported the overall objectives of capitalizing leases, a third did not support the changes and the remainder did not give their overall view of the paper. One of the largest concerns was with the complexity of the new model. Implementation and compliance would cost the companies money and many did not know if the benefits would outweigh the costs. Most of the comments that did not support the changes were from preparers. Preparers did not believe that the model accounted for the diverse and complex nature of leases. They also felt that the new model still allowed for judgement decision and manipulation. (FASB/IASB, Discussion Paper Comments, 2009)

In 2010, the FASB and IASB released their first joint exposure draft on leases. The exposure draft contains the proposed new accounting standards for leases. The boards looked at the comments they received from the discussion paper and made various changes to their previous model. This exposure draft proposed that the lessee recognize an asset and a liability based on their right to use the leased item and their obligation to make lease payments

(FASB/IASB, 2010). This is the same model that was proposed in the previous discussion paper.

The boards proposed a new scope for the lease standards. The standards will apply to all leases except:

- “Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets
- Leases between the date of inception and the date of commencement of a lease if they meet the definition of an onerous contract”

These lease agreements were all excluded in an attempt to simplify the standards. One of the most common complains the boards had received was that the new standards were too complex and would be expensive to implement. By excluding certain types leases companies could save time and money when the changes became final and they had to use the new standard.

The exposure draft also proposed a simplified model for short-term leases or leases with a maximum possible lease term of less than twelve months. If a lessee enters into a short-term lease they may elect on a lease-by-lease basis to not capitalize the lease. They have the option to follow the existing leasing standards for these short-term leases (FASB/IASB, 2010).

The exposure draft also outlined how the assets and liabilities would be measured at the date of inception. With the new proposal, assets and liabilities would be determined based on the longest possible lease term. This not only includes the standard lease term but also the terms associated with the option to extend or renew the lease. This is an important aspect when determining if a lease qualified as a short-term lease (FASB/IASB, 2010).

Finally, the exposure draft outlines the proposed disclosures companies must make regarding their leases. Companies must disclose quantitative and qualitative financial information. These disclosures must address nature of their lease agreement, the terms of the lease, and any extension options. For short-term leases they must disclose the value of the lease and that the lease exists. The company must also disclose information about the timing and uncertainty of cash flows arising from leases. The goal of these disclosures was to increase the transparency of the lease agreement (FASB/IASB, 2010). These disclosures could be used by financial statement users who want more information regarding the lease contracts that a company has.

The boards received many comments after the release of the 2010 exposure draft. Similar to the comments received on the discussion paper, most people supported the overall objectives of the exposure draft. Most people agree that the previous standards are flawed and something needs to change in order to improve the information provided on the financial statements. Many of the comment letters still criticized the newly proposed standards and voiced their concerns regarding the changes. People still believe that the new standards are too complex and the cost associated with implementing these standards outweigh the benefits. People believe that there will still be reduced comparability because of the heavy reliance on estimation for some of the measurements. People criticized the definition of lease, arguing that it was too broad and other arrangements could fall under the definition. The boards also held round table discussion and workshops where some people emphasized that the boards should focus more on providing high-quality standards and not worry about reaching project deadlines (FASB/IASB, Exposure Draft Comments, 2011).

In 2013, the two boards released their revised joint exposure draft. This is the final joint exposure draft that the FASB and IASB would release. Once again the boards reviewed the comments they received and made the necessary adjustments to their previous proposal.

This exposure draft went more in depth in identifying and defining a lease. It defines a lease as, “a contract that conveys the right to use an asset for a period of time in exchange for considerations.” (FASB/IASB, 2013). They go further in depth by identifying two criteria that a lease contract will have. These criteria are:

- “whether fulfilment of the contract depends on the use of an identified asset; and
- whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration”. (FASB/IASB, 2013)

This was one of the major concerns in the comment letters after the previous exposure draft. This new definition of the lease broadens the overall scope of the standards. Many companies will need to revisit their existing contracts and determine if under the new standards this contract is now considered a lease.

The boards also redefined the lease term for this exposure draft. The new lease term includes the non-cancellable period of the lease and the option to extend or terminate the lease if the lessee has a “significant economic incentive to exercise the option”(FASB/IASB, 2013).

The biggest change in this exposure draft was the addition of two classifications of leases. The boards proposed that leases are either a Type A lease or a Type B lease and the classification of the lease must be determined upon commencement of the lease and it cannot be changed. The major distinction between these two leases is whether or not the leased item is property or equipment. If the leased asset is equipment, the lease will be a Type A lease and if it is property it will be a Type B lease. The exception for Type A leases is if the lease term is an insignificant portion of the economic life of the asset or if the present value of lease payments is insignificant compared to the fair value of the asset. If either of these are true, then the lease is a Type B lease

(FASB/IASB, 2013).

The draft proposes that at the commencement date of the lease a lessee should record a right-of-use asset as well as a lease liability. The measurement of these is based upon the present value of lease payments. The recorded asset must include any costs incurred that are directly related to entering the lease. This applies to all leases that have a lease term of more than 12 months. If the lease term in less than 12 months, the lessee does not have to record an asset or liability on their balance sheet (FASB/IASB, 2013). Once again the boards excluded short-term leases from the new standard and will allow these leases to follow the old standards.

The boards received many comment letters regarding the 2013 revised exposure draft. Once again, many of the users of the financial statements support the model put forth by the FASB and IASB with regards to the recognition of assets and liabilities for leases. Many also agree that the current standards are flawed and changes need to be made. There are still many constituents who feel that the new proposal is excessively complex and the old model is better. Many of these people believe that the dual classification creates unnecessary costs and the board needs to perform a cost-benefit analysis to ensure that the new model is cost efficient (FASB/IASB, Exposure Draft Comments, 2013). There are also groups, specifically the Chartered Financial Analyst Institute (CFA), that believe that the Boards should release a standard now and make changes in the future as they see necessary. The Boards also received comments regarding the new standards for short-term leases. They argued that the standards for short-term leases should remain the same and not change (Chartered Financial Analyst Institute, 2013).

Where it went wrong

Up until August 24, 2014 (Katz, 2015) the FASB and IASB had worked diligently to produce a set of converged lease standards that would improve the overall quality of financial statements. In the end the two boards could not agree upon a single set of standards and they decided to go their separate ways. There were many internal and external forces that could have influenced the two boards and caused them to diverge. The boards have many parties that they must appease. They have to deal with constituents, regulatory bodies, political environment, and institutional issuers. Next, we will look at each of these parties and why each of them may have pushed the boards apart.

Constituents

One major factor involved in the FASB and IASB decision is what their constituents want. The changes to the leasing standards could affect many different parties. The preparers, users, auditors, academics, and actuaries will all have to make adjustments with the new standards. The two largest constituents are the preparers and users of the financial statements.

After the release of the 2013 exposure draft, the boards received 638 comment letters. These comments came from all different parties, but majority of them coming from financial statement preparers (FASB/IASB, Exposure Draft Comments, 2013). The overwhelming majority of these preparers disagreed with the new proposal. They believe that the changes do not fix the entirety of the problem and they will only increase the cost and complexity for the companies. This puts both boards in a precarious situation. The Financial Executives International group (FEI) is a group with over 10,000 members, all of whom are preparers of financial statements. Their members come from a broad spectrum of companies covering all different sizes and industries. The FEI submitted a comment letter to the FASB after the release of the 2013 Exposure Draft and they voiced their opinion on the problems with the proposed changes. They agreed with the overall goal of the new standards but they believe that the new standards are overly complex and will make matters worse in the long run (Financial Executives International, 2013).

The next important constituent is the user of the financial statements. According to the mission and vision on their website, The Chartered Financial Analyst Institute (CFA) is an association who want to promote fair and transparent global capital markets and protect investors. They represent the users of the financial statements. They have long advocated for a change to leasing standards. The CFA believes that under the old standards, investors are not able to make an accurate assessment of a company's financial statements. In the CFA's comment letter regarding the 2013 Exposure Draft they brought up many parts of the proposed model that needed more work. However, their biggest concern was that further changes would only delay the implementation of a new model. They encouraged the boards to complete and implement their new standards, while allowing for further changes to be made as problems arise in the future (Chartered Financial Analyst Institute, 2013).

SEC, European Commission and other Regulators

While the FASB is responsible for developing GAAP, the SEC is responsible for enforcing the laws and ensuring companies follow the standards. The SEC was originally charged with developing and enforcing the accounting standards but in 1973 they established the FASB as a private independent organization that develops financial accounting standards (FASB, Timeline). The SEC gives the FASB the power to make their own decisions but the SEC is always allowed to step in and oversee a project. The SEC has shown to have influence over the FASB when it comes to convergence (Herdman, 2002).

Christopher Cox was the Chair of the SEC from 2005 to 2009 (U.S. Securities and Exchange Commission, History of Chairmen). Cox was a huge supporter of convergence and he pushed the FASB and the IASB to converge in as many places as possible. Cox believed that the use of IFRS in the United States would benefit US investors (Cox, 2007). Cox was fired in 2009, after the economy crashed, and with his departure the SEC's driving force behind convergence went away. The next Chair of the SEC was Mary Shapiro. Shapiro did not abandon the idea of convergence but she was much more focused on doing what was best for the US. She wanted the primary focus of the SEC to be on what was best for US investors and believed that the FASB should remain as the ultimate standard setter for US companies. With Shapiro at the head of the SEC, the push for convergence was not nearly as strong as it had been in the past (Katz, 2015).

The SEC took a major step towards convergence in 2008. Previously, companies that filed using IFRS had to reconcile net income and shareowners' equity to GAAP standards if they wanted to be traded on the US markets. This caused lots of issues for foreign companies who wanted to move into US markets because their financial statements were under tremendous scrutiny because of the changes that they had to make to comply with GAAP. They announced in a 2008 International Series Release, that when companies who adhered to the IFRS as issued by the IASB no longer had to reconcile their financial statements to GAAP. This marked a major step towards acceptance of IFRS by the SEC.

Political environment

There are two major political groups who have influence over the FASB and the IASB. In the United States the congress has an influence over the decisions that the FASB makes. The major political group internationally is the European Union (EU) and specifically the European financial Reporting Advising Group (EFRAG). Both congress and the EFRAG have oversight over the development of new accounting standards. The political influence is very similar to that of the SEC. Congress and the EFRAG are able to influence the FASB and IASB in certain directions depending on what they want to get done.

Institutional Issues

The last major influence that led to the failed attempt of lease convergence was the issues that are present within the two boards. If there were a single set of internationally accepted accounting standards there would be no need for the FASB. The FASB would no longer need to develop accounting standards here in the US and it is likely that the IASB would be the board in charge of creating the international standards. Certainly some FASB members would move over to the IASB but most likely, many of the members will lose their job. With this in mind, the FASB is less likely to go above and beyond to achieve convergence. Especially when those outside forces like the SEC or congress are not pushing them to do so.

New Lease Standards- International

In January of 2016, the IASB released their new leasing standards, IFRS 16 *Leases*. The IASB decided to eliminate the dual classification of leases and instead opt for a single type of lease. All leases other than short-term leases and low-value asset leases are accounted for using the new method. The FASB defined a short-term lease as any lease that has a lease term that is less than 12 months long and defined a low value lease as any lease where the leased asset is valued at less than $5,000. These short-term and low value leases allow for the lessee to make a decision on how they will record the lease. They can either opt to follow the new standard or they can choose to use the old standard (IFRS 16 *Leases*, 2016). These exceptions were added in order to simplify lease accounting and reduce costs for companies. The majority of leases will be recorded similar to the proposed method in the 2010 exposure draft. There is a single method for recording leases and all lease transactions capitalized on the balance sheet.

With the new standard, a lease is a contract that gives the customer (lessee) the right to use an asset for a period of time in exchange for consideration. The right to use an asset is determined if throughout the term of the contract the lessee has the right to:

1. "Obtain substantially all of the economic benefits from the use of the identified asset; and
2. direct use of the identified asset (how and for what purpose the asset is used)." (Ernst & Young Summary of IFRS 16, 2016)

For lessee accounting there are three major considerations. These are: initial recognition/measurement, subsequent measurement and presentation. For initial recognition and measurement the lessee is required to record a lease liability for the lease payments and a right-of-use asset for the right to use the underlying asset for the duration of the lease term. The lease liability is recorded at the present value of the lease payments to be made over the lease term. The value of the asset will be calculated based on the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs and an estimate of restoration, removal and dismantling costs (Ernst & Young Summary of IFRS 16, 2016).

For subsequent measurements the lessee adjusts the liability to account for interest and reduces the liability when lease payments are made. The asset to depreciated in accordance with

IAS 16 *Property, Plant and Equipment*. The lessee must also make the necessary adjustments to the lease liability if certain events happen. If there is a change in the lease term or a change in variable rent based on an index or rate change. The asset must also be tested for impairment using IAS 36 *Impairment Property* (IFRS 16 *Leases*, 2016).

For presentation, a right-of-use asset is either presented separately from other assets or there must be a disclosure identifying these assets. The same is true for lease liabilities. Depreciation and interest expense cannot be combined in the income statement (IFRS 16 *Leases*, 2016).

For the lessor there are very few changes with how the lease is recognized. The lessor will continue to recognize their leases as either a operating or finance lease.

New Lease Standards- United States

In February of 2016, the FASB released their new lease standard, FASB ASC Topic 842, Leases. They took a very different approach than the IASB. The FASB opted to stay with the two different types of lease transactions. They call these two types of leases either operating leases or capital leases. The important part of the new standard is that both types of leases will be capitalized on the balance sheet (FASB, ASC 842).

The first thing that the new lease standards addressed was the scope of the standards. The new standard included leases of all property, plant and equipment but it excluded leases of intangible assets, leases to explore for or use nonregenerative resources, leases of biological assets, leases of inventory, leases of assets under construction.

Next the FASB gave their definition of a lease. It defines a lease as "[a] contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. " (FASB, ASC 842). For a contract to be a lease the FASB said it must:

1. "Depend on the use of an identified asset
2. convey the right to control the use of the asset over the lease term." (FASB, ASC 842)

At the commencement of the lease the lessee must determine if the lease is an operating or financing lease. A lease is a financing lease if the lessee obtains control of the underlying asset. According to ASC 842-10-25-2, control of the underlying asset happens if one of the following criteria is met:

- "The lease transfers ownership to the lessee at the end of the lease term
- The lessee has a bargain purchase option
- The lease term is for the majority of the remaining economic life of the asset
- The present value of the lease payments, plus the residual value, amounts to at least substantially all of the fair value of the leased asset
- The underlying asset is specialized such that it is expected to have no alternative use to the lessor at the end of the lease term."

These criteria are similar to the previous standards for identifying a capital lease but they removed the "bright line" or quantitative thresholds. The FASB did however say that the previous thresholds are reasonable for assessing the criteria (PWC Leases, 2016).

Under the new standards the lessee will generally have to record a right-of-use asset and a lease liability based on the present value of the remaining lease payments for both operating and finance leases. Lessees will also capitalize initial direct costs as part of the right-of-use asset as well as be required to assess the asset for impairment using ASC 360, *Property, Plant, and Equipment* (FASB, ASC 842).

If the criteria in ASC 842-10-25-2 are not met then the lease is classified as an operating lease. The lessee will record rental expense according to the previous standards, ASC 840. Rental expense will be recognized on a straight-line basis over the term of the lease. Rental expense for finance leases will be recorded in the same manner.

While both types of leases require the lessee to recognize a right-of-use asset and a lease liability on their balance sheet the income statement presentation differs between the two. With operating leases a single lease cost is allocated on a straight-line basis over the term of the lease. With finance leases interest on the lease liability is separate from the amortization of the right-of-use asset on the income statement. The presentation of a finance lease under the new standards is similar to the presentation of all leases under the new IASB standards (PWC Leases, 2016).

Side-by-Side Comparison of FASB ASC Topic 842 and IFRS 16

The biggest difference between the new FASB standard and the new IASB standard lies in the new accounting model for leases. The old standards had the two classifications of leases. The FASB opted to stay with the dual classification of leases while the IASB opted for a single classification of leases.

There are also differences in what the two standards consider a lease. The FASB opted for leases to only cover contracts regarding Property, Plant and Equipment (FASB, ASC 842), while the IASB decided to have leases cover all types of assets (IFRS 16 *Leases*, 2016). The IASB also chose to exclude low-value assets, or any contracts for assets under $5,000. It is also important to note that companies do not have to aggregate leases below $5,000 for materiality considerations.

Many leases have variable lease payments, which depend on a specific index or rate. Under FASB ASC 842 the lessee does not have to remeasure payments unless they are reassessing the lease obligation for other purposes. Under IFRS the payments must be remeasured and whenever the index or rate changes.

There are also differences in how companies will account for shot-term leases. Both standards allow for leases that have a lease term of less than 12 months to be exempt from the new standards, but there is a difference in how the lease term is calculated between the two standards. Under GAAP if there is a purchase option it depends on the likelihood of the lessee to exercise that option when determining if it should be included in the lease term (FASB, ASC 842). Under IFRS the lessee does not include any purchase options in their determination of the lease term (IFRS 16 *Leases*, 2016).

What does it mean for companies?

The new standards are not being firmly implemented until 2019 for companies with a fiscal year end of December 31. However, the SEC requires companies to provide three years of comparable income statements so companies will have to make the necessary changes to the 2017 and 2018 financials by their 2019 statements. A company called, Lease Accelerator completed a study in May of 2016 where they asked various professionals about the new standards and how their companies were doing with implementation of the new standards. Their results showed that most were in the early stages of learning about the new standards and beginning to work out how they would go about implementing the new rules. Very few companies claimed that they were actually ready for the new standards. 42% of the people the questioned called the new standards. “pretty painful” or “extremely painful” and 3% claimed the new standards are “more painful than a root canal”. Another major issue that companies voiced was the amount of time it would take to determine the total number of operating leases the company has. These responses varied from a few minutes to a couple of months. It is difficult for small firms with less sophisticated accounting systems to keep track of all of this information but it is also difficult for large companies that may have thousands of operating leases at one time. With large companies comes more decentralization of information. (Lease Accelerator, 2016) The party responsible for making these changes does not always know exactly where the leased asset is, whether it has been impaired, damaged, or stolen and this only becomes more difficult the longer the lease term.

The survey also asked these companies what the potential effects of the new standards might mean for their company. Nearly 50% claimed that it would result in higher Total Cost of Ownership. Many also claimed that it would cause a delay in equipment acquisitions, it would reduce cash flow and it would reduce capital expenditures. Many of the companies who claimed the higher total cost of ownership were primarily worried about some of their current leases where they have a piece of equipment for a couple of years then when the lease is up they lease a newer version of the equipment. When they do purchase equipment they plan on holding that equipment for a long period of time. By leasing equipment over long periods of time companies can stretch payments over many years, which does not have as large an impact on their short-term budget. Capital expenditures require a much larger upfront cash outlay and require a lot longer approval process (Lease Accelerator, 2016).

An important aspect of the new standards is that existing leases would have to be changed to meet the new standards. Companies will have to reevaluate all of their existing lease agreements and determine the new lease terms and subsequent lease payments (Cherry Bekaert, 2016). Companies will record more leased assets as well as leased liabilities.

The level of change will depend heavily on how many operating leases a company currently has. This can vary drastically between industries and even between companies in industries.

Methodology

I used various documents released by the FASB and IFRS to analyze and answer this question. By looking at the documents, I was able to gain a deeper understanding of the process by which to two boards develop their standards and some of the potential issues that the two boards may have faced along the way. I started with the earliest joint documents released regarding leases in order to grasp why leases were such a major problem. The research papers released by the G4+1 in 1996 and 2000 discuss in depth why the FASB and the IASB believe that lease standards need to be changed. I was able to see how the proposed standards changed as time progressed. I was also able to see the changes the board made in response to the comment letters. I supplemented these documents with various research papers written on the topic of leases and convergence. The new leasing standards came out so recently that there was not much academic literature written specifically on the new standards or the changes that these new standards will cause. I was able to find various opinion-based articles regarding the new changes as well as a few studies that quantified the changes and explained how they may affect companies.

Conclusion

Through my research I determined that the FASB and the IASB were not successful in converging their new accounting standards. Leases could have been a major step towards convergence as a whole. While I believe the boards failed with the objective to converge the standards I do believe that their standards are successful in other ways. The main objective of changing lease accounting standards was to improve financial statement transparency and to move leases to the balance sheet. The two sets of standards went about achieving this in different ways but in the end I believe they were both successful with this objective.

The future of convergence is looking grim for the time being. Currently, there are no major projects that the boards are working towards convergence on. It is impossible to tell what exactly the future of convergence will look like. There are many factors that could determine what the future looks like. The next chair of the SEC could be pro-convergence and they may begin the push for convergence once again. It is impossible to tell what the future will hold and whether the two boards will revive the push for convergence or whether they will let it die away.

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