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FASB and IASB Harmonization of Leases

Robert G. Morgan, Martha M. Pointer, Gary G. Berg
(East Tennessee State University, Johnson City, TN 37614, USA)

Abstract: In an effort to harmonize worldwide accounting standards, the two primary parties, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), are taking a topic-by-topic approach in an attempt to develop accounting standards that are acceptable to both bodies. Upon completion of this project, the similar accounting standards will be used worldwide. However, the harmonization of accounting standards is made more difficult by the different approaches taken toward accounting standards setting. The FASB uses a rules-based approach to standard setting while the IASB uses a principles-based approach. The current project under discussion by the two boards is one of the more difficult areas to harmonize — accounting for leases.

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In an effort to harmonize worldwide accounting standards, the two primary parties, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), are taking a topic-by-topic approach in an attempt to develop accounting standards that are acceptable to both bodies. Upon completion of this project, the similar accounting standards will be used worldwide. However, the harmonization of accounting standards is made more difficult by the different approaches taken toward accounting standards setting. The FASB uses a rules-based approach to standard setting while the IASB uses a principles-based approach. The current project under discussion by the two boards is one of the more difficult areas to harmonize-accounting for leases.

The joint FASB and IASB committee has been discussing the harmonization of lease accounting since 2009. The boards issued the first exposure draft in 2010; however, many concerns about the proposed treatment of leases were brought to the boards' attention. It is expected that a second exposure draft will be issued in mid-2013. The topics addressed in the second exposure draft include the accounting for leases during a transition period, the scope of the new standard, the lessor accounting for leases, and several other areas of clarification of the material in the first exposure draft.

The most controversial change being proposed relates to the recognition, in the balance sheet, of the assets and liabilities related to ALL leases with a term of 12 months or more. This change will reduce the amount of off-balance sheet financing now used by many firms; thereby having substantial negative impacts on the total debt

Robert G. Morgan, Ph.D., CMA, Professor of Accounting, College of Business and Technology, East Tennessee State University; research areas/interests: financial accounting. E-mail: Morgan@etsu.edu.
Martha M. Pointer, Ph.D., CPA, Professor of Accounting and Associate Dean, College of Business and Technology, East Tennessee State University; research areas/interests: financial accounting. E-mail: Pointer@etsu.edu.
Gary G. Berg, Ph.D., CPA, Associate Professor of Accounting, College of Business and Technology, East Tennessee State University; research areas/interests: managerial accounting. E-mail: Bergg@estu.edu.

reported on firms' balance sheets. Members of the US Congress sent the FASB a letter requesting the proposed change be eliminated (Cohn, 2012). Leasing companies have lobbied for the removal of the reporting of leases with a life of more than 12 months (Cohn, 2011). However, the political pressure has not changed this aspect of the proposed lease standard. The recognition of these short-term leases reduces the necessity of drawing a "bright line" between capital leases and operating leases, but an analysis of the differences between the FASB and the IASB positions highlights the difficulty in reaching a common set of accounting standards.

1. IASB Rules for Capitalization of Leases

The IASB has taken the position that any lease which is similar to an installment purchase is a financing lease (referred to as a capital lease by the FASB) and must be capitalized. If the lease is not similar to an installment purchase it should be treated as an operating lease and costs are expensed as they are incurred. To determine whether it is a financing lease or an operating lease, the lease documents are analyzed in light of the following five rules:

(1) Does the lease transfers ownership of the asset to the lessee by the end of the lease term?

(2) Does 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 for it to be reasonably certain, at the inception of the lease, that the option will be exercised?

(3) Is the lease term for the major part of the economic life of the asset even if title is not transferred?

(4) At the inception of the lease, does the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset?

(5) Are the leased assets of such a specialized nature that only the lessee can use them without major modifications? (IAS 17, para. 10)

If the answers to any of the five questions are yes, then the lease is a financing lease and capitalized. If the answers to all five questions are no, then it is an operating lease and all costs are expensed. In answering the five questions, the content of the lease is analyzed rather than the form of the lease. Several indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(1) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(2) any gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

(3) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent. (IAS 17, para. 11)

The IASB has concluded that the classification of a lease is to be based on the substance of the transaction rather than the form. In essence it is up to the accountant to use their professional judgment in determine whether a lease is a financing lease or an operating lease.

2. FASB Rules for Recognition of Leases

The FASB has very specific rules in determining whether a lease will be classified as a financing (capital) lease and capitalized or an operating lease and expensed as the costs are incurred. To determine how the lease is to be categorized, both the lessee and a lessor must consider the terms of the lease using the following four criteria:

(1) Does the lease transfers ownership of the property to the lessee by the end of the lease term? This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.

(2) Does the lease contain a bargain purchase option?

(3) Is the lease term equal to 75 percent or more of the estimated economic life of the leased property? However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

(4) Does the present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. (FASB para. 7)

The FASB requirement is that if the answer to any of the four questions is yes, then the lease is a financing lease and must be capitalized. If the answers to all four questions are no, it is an operating lease and is not capitalized.

3. Comparison of IASB and FASB Rules

(1) Rule # 1

IASB: Does the lease transfers ownership of the asset to the lessee by the end of the lease term?

FASB: Does the lease transfers ownership of the property to the lessee by the end of the lease term?

The only difference between IFER and FASB is that the former uses the term asset while the latter uses the term property. Thus, the rules are essentially identical.

(2) Rule # 2

IASB: Does the lessee have 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 for it to be reasonably certain, at the inception of the lease, that the option will be exercised?

FASB: Does the lease contain a bargain purchase option?

The differences between IASB and FASB relates to whether the bargain purchase option will be exercised. The IASB states that based on reasonable judgment at the inception of the lease agreement that the bargain purchase option will be exercised. The FASB simply states that the lease contains a bargain purchase option and there is no consideration as to whether the bargain purchase option will be exercised.

(3) Rule # 3

IASB: Is the lease term for the major part of the economic life of the asset even if title is not transferred?

FASB: Is the lease term equal to 75 percent or more of the estimated economic life of the leased property? However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

The IASB rule states that the lease is for a major part of the assets economic life. The judgment as to what constitutes the major part of the economic life is left to the accountant's discretion. The FASB has a rule that if the lease term equals 75 percent or more of the economic life of the lease asset it must be capitalized and treated as a financing lease. Other than estimating the length of the economic life of the leased assets, the accountant operating under the FASB rules does not have any discretion concerning the accounting for the lease. The difference concerning the percentage of economic life that requires a transaction is a clear example of the FASB being a rules-based accounting standards-setting entity and the IASB being a principles-based accounting standard-setting entity.

(4) Rule # 4

IFER: At the inception of the lease, does the present value of the minimum lease payments amount to at least substantially all of the fair value of the leased asset?

FASB: Does the present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

The IASB rule states that the present value of the minimum lease payment must be at least substantially all the fair market value of the leased asset. This allows the accountant recording the transaction to use professional judgment concerning what substantially means. The FASB, on the other hand, defines the percentage that the present value of the minimum lease payment must meet. Under the rules adopted by the FASB, if it is equal to or greater than the 90 percent of the economic life then it is a financing lease and must be capitalized. If it is less than 90 percent, then is an operating lease and all expenses will be expensed as incurred.

(5) Rule # 5

IFER: Are the leased assets of such a specialized nature that only the lessee can use them without major modifications?

The FASB has no rule concerning the specialized nature of a leased asset. Thus, this IASB requirement has no FASB counterpart.

4. Conclusion

The IASB standards were developed using a principles-based approach, and the FASB standards were developed using a rules-based approach. The differences that result from developing standards using two different approaches may be difficult to reconcile. There appear to be three methods for achieving harmonization: (1) the FASB will have to forego the comfort of having the rules that protect accountants them from legal battles that ensue when those rules are open to interpretation, (2) the IASB is going to sacrifice the accountant's ability to use professional judgment in determining the proper reporting for uncertain items, or (3) the IASB and the FASB will have to negotiate standards that are somewhere between the two approaches. The accounting for leases is an excellent opportunity for both standard-setting bodies to work towards true harmonization of accounting standards.

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