

# Lease accounting research paper examples

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## **Introduction:**

Leases are the contractual agreement among the lessor (the owner of assets) and the lessee, where the former party allows the latter to use the assets for a specified period of time in lieu of lease payments.

It is important to note that leases are classified as Operating Leases and Capital Leases. A Capital lease refers to purchase of an asset owned by lessor by using debt financing. Thus, at the inception of a lease, the lessee will add equal amounts of both asset and liability on the balance sheet.

Since, the asset is purchased through debt financing, lessee will recognize depreciation expense related to asset and also interest expense in relation to debt acquired to purchase that asset. On the contrary, operating lease is a rental agreement between lessor and lessee. Thus, under operating lease agreement, lease payments are simply recognized as rental expenses in the income statement of the entity.

## **Lessee's Perspective: Difference between IFRS and US GAAP Treatments**

Under IFRS, the lease is classified by the economic substance of the transaction, if substantially all the rights and risks of ownership are transferred to the lessee; the lease is classified as a finance lease. Following are the criteria, that if fulfilled, the lease is classified as finance lease;

- If the entitlement to the lease is transferred to the lessee at the end of the lease.
- At the concluding year of lease agreement, leased asset can be purchased by lessee at a price which is less than the fair value of the asset.
- A significant portion of economic life of the leased asset is covered under

lease agreement.

- The present value of the lease payments to be received in the future is equal to the fair value of the leased asset.
- The physical or technical properties of the leased asset is so technical that only the lessee can use the asset without any major alterations to the asset functioning.

In concern for treatment of lease accounting under GAAP, the rules are similar to IFRS but GAAP treatments are more specific than under IFRS. Thus, a lessee is required to consider the lease as finance lease if “any” of the following conditions are met:

- If the entitlement to the lease is transferred to the lessee at the end of the lease.
- The lease period is 75% or more of the asset’s economic life.
- A bargain purchase option permits the lessee to purchase the leased asset for a price that is lower than the fair market value of the asset at some future date.
- The present value of lease payment is 90% or more of the fair value of the leased asset.

Thus, if any of the above criteria is not met, the lease will be classified as an operating lease. From the perspective of lessee, he will always prefer to enter into an operating lease because no liability will be reported under an operating lease and hence better ratios will be achieved.

## **Summary: Lessee Perspective and treatment under IFRS and US GAAP**

Both GAAP and IFRS require that the lessee bears all the risk and even entitlement to reward of ownership of the leased property to recognize the leased asset. Also, both standards have laid the criteria on the basis of which the lease is accounted as an operating lease or financing lease. However, the criteria laid by GAAP are more specific than IFRS.

However, in either of the standards i. e. US GAAP or IFRS, lessee records the finance lease by recording asset and a corresponding liability of a same amount and for operating lease; he records rental expenses relating to lease payments.

## **Lessor's Perspective: Difference between IFRS and GAAP Treatments**

Even from the perspective of lessor, the lease is classified as either an operating lease or financing lease. Under IFRS, classification by the lessor is the same as that of lessee i. e. if the rights and risk of ownership are transferred to the lessee, the lease will be treated as a financing lease else it is accounted as operating lease. Contrary to it, under US GAAP, if any of the criteria for financing lease (discussed above) is met and the lessor is reasonable sure of collectability of lease payments, the lessor must treat the lease as financing lease. Otherwise, it is treated as operating lease.

In either of the accounting standards, if the lease is an operating lease, the lessor recognizes rental income for lease payments, while the asset is reported on his balance sheet and is regularly depreciated. While for financing lease, the lessor removes his asset from the balance sheet and

replaces it with a lease investment account (lease receivable).

i) Lease Reporting by Lessor: Difference in treatment of GAAP and IFRS

### **Types of Leases and their treatment under GAAP by the lessor:**

Sales type lease is treated as if the lessor sold the asset for the present value of the lease payment and provided the loan to the buyer in the same amount. Thus, at the inception of the lease, the lessor recognizes a sale equal to the present value of the lease payments and cost of goods sold is equal to carrying value of the asset.

Under this lease agreement, lessor recognizes a sale amount i. e. present value of the lease payments and corresponding to it, he accounts for cost of goods sold i. e. carrying value of the asset and the difference between them is shown as Gross Profit. Finally, the asset is removed from the balance sheet and amount equal to lease receivable is created which is equal to present value of lease payments.

### **Direct Financing Lease:**

In a direct financing lease, lessor does not account for any gross profit because the present value of the lease payment is equal to the carrying value of the leased asset; the lessor is simply providing a financing function to the lessee. Just as sales type lease, the asset is removed from the balance sheet and amount equal to the lease receivable is created which is equal to present value of lease payments.

## **Types of Leases and their treatment under IFRS by the lessor:**

IFRS does not distinguish between a sales type lease and a direct finance lease. However, a similar treatment to a sales type lease is allowed under IFRS for financing lease of manufacturers. Under this agreement, the present value of lease payment exceeds the carrying value of the asset.

Some other differences between IFRS and GAAP standards over accounting for leases:

## **Works Cited**

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