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HONORS THESIS ABSTRACT

With the global use of International Financial Reporting Standards (IFRS), the United States is facing the dilemma of whether to convert to these standards or converge them with U.S. Generally Accepted Accounting Principle (GAAP) in an effort to remove the major differences between standards. One set of global financial reporting standards would improve the comparability of financial statements around the world, but the Securities & Exchange Commission believes the standards need further improvement, before the U.S. takes any major steps to convert. I conducted research, focusing on professional journals, publications from the Big Four accounting firms, and standards issued by the IASB and the FASB. I examined the differences between U.S. GAAP and IFRS, looking specifically at the accounting treatment for leases, and the impact a major change in reporting standards would have on public companies, accounting firms, and the education system. After conducting thorough research, I determined that The U.S. needs to continue the convergence effort to ensure that in the future, U.S. financial reporting standards will be of high-quality. While one set of global financial reporting standards is beneficial, it is not something that can’t be rushed into. The U.S. needs to take the time to properly prepare, not just public companies and the education system, but the standards as well.
With International Financial Reporting Standards (IFRS) being used in over 100 countries, the United States is feeling pressure to convert (McCann, 2009). One set of global financial reporting standards would improve the comparability of financial statements around the world, but the SEC believes that the standards need further improvement, before the U.S. takes any major steps to convert. “We do have the best reporting system, but the rest of the world will not accept it ... It’s too detailed for them,” states FASB Chairman Robert Herz about U.S. Generally Accepted Accounting Principles (Johnson, Goodbye GAAP, 2008). This view seems to be consistent with that of many Americans, but U.S. public companies are beginning to feel the impact of global conversion. Not utilizing IFRS is affecting public companies’ ability to remain competitive in global markets, but only the largest 100 to 300 U.S. companies have significant enough foreign operations to justify moving to IFRS (Leone, 2009). Making a transition will require a huge capital outlay and affect many areas of a company’s operations. It’s important to understand the conversion/convergence efforts currently taking place in the U.S., how standards are created, the differences in standards, and the impact principles based standards will have on public companies, accounting firms, and the education system in the United States.

**Conversion**

In 2007, the SEC announced that foreign filers are no longer required to reconcile their financial statements to U.S. GAAP, as long as they use International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB) (Bunting & Frank, 2008, 5). This was a major step towards implementing IFRS in the United States. Shortly after removing this requirement, the SEC issued a timeline for proposed conversion to IFRS for U.S. public companies (SEC Road Map for Transition to IFRS Available, 2008). According to the timeline,
U.S. companies could opt to use IFRS as early as 2009, with large accelerated filers making the transition by December 2014 (SEC Road Map for Transition to IFRS Available, 2008). The remaining accelerated filer and non-accelerated filers would make the transition by 2015 and 2016, respectively (SEC Road Map for Transition to IFRS Available, 2008). This timeline would reduce the cost of conversion for public companies, but would require that both IFRS and U.S. GAAP standards be used in conjunction while the conversion is taking place (SEC Road Map for Transition to IFRS Available, 2008).

Conversion would require that U.S. public companies completely discontinue the application of U.S. GAAP and begin using IFRS, which poses several problems. First of all, people worry about the quality of IFRS, as well as the independence and sustainability of the IASB. The increased reliance on judgment under IFRS can lead to inconsistent application of the standards from country to country, hindering the quality and comparability of the standards. Not to mention, a transition to IFRS could mean that overseas standard setters have control over accounting in the U.S. (Johnson, What if IFRS Replaced GAAP, 2007). Ultimately, the United States will either have less control over its own standards or some differences will remain between IFRS and U.S. standards (Rappeport, 2008). The possible transition raises several questions that need to be addressed before any further action to convert is taken. The SEC
determined that several improvements need to be made in the following areas: international standards, accountability and funding of the International Accounting Standards Committee Foundation (IASC), education, and training in U.S. With IFRS being used in over 100 countries, U.S. conversion could greatly improve the competitiveness of U.S. companies in global markets, but many Americans believe that further convergence is needed before the U.S. makes a definite decision (McCann, 2009; Munter, 2010, 46). Taking steps to resolve the major differences between standards is a step in the right direction.

**Convergence**

Almost every major country outside the U.S. currently uses, or plans to convert to, International Financial Reporting Standards (Bunting & Frank, 2008, 5). With all of the obstacles hindering conversion in the U.S., the Securities & Exchange Commission has taken steps to converge U.S. GAAP with IFRS. In 2002, the FASB and the IASB issued the Norwalk Agreement, officially beginning the convergence effort (Deloitte, IFRS’s in Your Pocket, 2009). In this agreement, the two standard setters, the IASB and the FASB, agreed to resolve the major differences between IFRS and U.S. GAAP (Munter, 2010, 44). There are two main goals for convergence (Deloitte, 2009):

1. To make financial reporting standards more compatible
2. To coordinate future efforts to ensure that compatibility is maintained

By merging the two sets of standards, standard setters aren’t necessarily making IFRS and U.S. GAAP identical, but they are resolving the major differences between the two in an effort to improve the comparability of financial statements prepared under either set of standards (Leone, 2009). This would make reconciling much easier and allow the U.S. to maintain control over its own set of standards. For the last 5-10 years, the FASB has been working with the IASB to
resolve these major differences (Deloitte, IFRS’s in Your Pocket, 2009). After releasing the Memorandum of Understanding (MOU) in 2006, the standard setters began meeting monthly to discuss possible changes regarding the accounting for leases, income taxes, business combinations, and other major topics in an effort to speed up the convergence process to meet their original 2011 deadline (Munter, 2010, 44). As the U.S. approaches this deadline, U.S. GAAP standards issued by the FASB are becoming more principles based. The SEC plans to wait one year after publishing the converged standards to implement them in the U.S., after which it will wait another two years to review the effectiveness of the standards, according to the IASB chairman David Tweedie (Defelice, 2009).

Although the FASB and the IASB are currently working on converging the two sets of standards, it is a very real possibility that conversion will still take place in the U.S. before the convergence projects are complete. “Allowing U.S. companies to file under IFRS before the convergence projects are complete would hinder convergence, instead of contributing to the goal of a single set of high-quality standards; offering all U.S. companies a choice between GAAP and IFRS before a significant number of IFRS flaws are corrected, could lead to a uniform set of standards-but low-quality,” notes Sarah Johnson in an article for CFO Magazine (Johnson, SEC Allows Dual Accounting System, 2007). However, the SEC is not concerned with the possibility of conversion hindering convergence efforts (Johnson, SEC Allows Dual Accounting System, 2007). No matter what the SEC decides to do, inevitably U.S. standards are going to become more and more principle based; whether or not that’s a good thing depends on who you talk to. While the FASB and the IASB are working together to converge standards, they both come from very different backgrounds and have different views on creating standards. When considering the
quality of the two sets of standards, it is important to consider the manner in which the standards are created.

**Standard Setting**

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are the major standard setting bodies for Generally Accepted Accounting Principles in the United States (GAAP) and International Financial Reporting Standards (IFRS), respectively. The SEC’s main concern is the independence and professionalism of these standard setters. Therefore when evaluating them, it’s important to consider how they are funded, who oversees them, and how they go about setting standards.

**FASB**

Established in 1973 (FASB, 2010), the Financial Accounting Standards Board (FASB) is the primary standard setter for U.S. GAAP. The FASB is an independent organization whose mission is to, “establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information” (FASB, 2010). It is overseen by the U.S. Securities & Exchange Commission, who evaluates its independence and accountability (FASB, 2010). The board is made up of five members who can serve up to two five-year terms (FASB, 2010). Each member must be knowledgeable in accounting, finance, and business, while showing a concern for the public interest (FASB, 2010). The FASB has a permanent source of funding, the majority of which comes from the sale of publications and licensing agreements; the remainder consists of contributions from the public accounting profession and academic communities (AICPA, 2002). This allows the FASB
to maintain its independence as a standard setter, as well as its accountability for the public interest.

The FASB follows a specific process when creating and implementing GAAP in the United States. First of all, the FASB receives recommendations and other requests to improve existing standards or create new ones (FASB, 2010). Once a recommendation is received, the FASB Chairman, Robert Herz, determines whether to address it further with approval from the Board of Trustees and other FASB members (FASB, 2010). The FASB then holds public meetings, where they analyze these issues (FASB, 2010). After deliberating, they issue an Exposure Draft open for public comment (FASB, 2010). The board reviews any comments received and redeliberates (FASB, 2010). Once a final decision is reached, the FASB issues an Accounting Standards Update regarding any changes made (FASB, 2010).
IASB

The International Accounting Standards Board (IASB) issues IFRS and related interpretations for over 100 countries around the world (Langmead & Soroosh, 2009, 18). It was originally created by the International Accounting Standards Committee Foundation (IASC) in 2001, whose International Accounting Standards (IAS) are still in use (Langmead & Soroosh, 2009, 18). Contrary to the FASB, the majority of funding for the IASB comes from donations and it has no governing body to oversee it (Johnson,
IASB Looks for a Parent, 2007). This presents a potential conflict of interest, hindering the IASB’s independence and ability to consistently apply a global set of financial reporting standards (Johnson, SEC Allows Dual Accounting System, 2007). As a result, new sources of funding are being considered. Countries that use IFRS will potentially be required to fund the IASB through registration fees (Johnson, IASB Looks for a Parent, 2007). Furthermore, steps are being taken to create a governing body to oversee the IASB, known as the Monitoring Board, which will comprise the U.S. Securities & Exchange Commission, the International Organizations of Securities Commission (IOSCO), the European Commission, and the Japan Financial Services Agency (Deloitte, IFRS’s in Your Pocket, 2009).

The IASB has a standard setting process, similar to that of the FASB. First, the IASB is asked to review certain topics regarding the application of IFRS (Deloitte, IFRS’s in Your Pocket, 2009, 9). Members of the IASB then review accounting requirements and practices, consulting with national standard setters (Deloitte, IFRS’s in Your Pocket, 2009, 9). Then, they confer with the Standards Advisory Council about adding the topic to IASB’s agenda (Deloitte, IFRS’s in Your Pocket, 2009, 9). Once an advisory group is formed and has reviewed all the necessary information, a discussion paper is published (Deloitte, IFRS’s in Your Pocket, 2009, 9). The IASB then votes on whether to approve an Exposure Draft for public comment (Deloitte, IFRS’s in Your Pocket, 2009, 9). Once approved and a comment period has been established, the IASB reviews any comments received (Deloitte, IFRS’s in Your Pocket, 2009, 9). Members vote again on the final
standard, requiring nine votes to pass any changes (Deloitte, IFRS’s in Your Pocket, 2009, 9).

In order to meet investor’s expectations and successfully apply IFRS globally, the IASB needs to make several improvements. As Cynthia Bolt-Lee and L. Murphy Smith comment (2009), “Quality depends more on the manner in which standards are enforced than the differences in standards themselves.” Therefore, IASB needs to find a permanent source of funding and create an authoritative body to oversee it, in order to improve the
quality of IFRS. The IASB is currently taking steps to resolve these issues and ensure that IFRS is consistently applied across the globe. Since the FASB and the IASB have different views on creating standards, the standards they issue are very different.

**Leases**

One of the major convergence projects the IASB and the FASB are currently working on is the accounting for leases. A lease is a legal contract between two parties, allowing one firm (the lessee) to have exclusive possession over another firm’s (the lessor) property for a specific period of time in exchange for compensation. U.S. GAAP and IFRS have two different ways of classifying and accounting for leases, although some similarities do exist. The IASB and the FASB expect to have an Exposure Draft on the converged accounting treatment available for comment by June 2010, with the final converged standard ready to issue by July 2011 (KPMG, 2010).

**U.S. GAAP**

Under U.S. GAAP, how a lease is accounted for depends on which side of the transaction you are on. For the lessee, there are two types of leases: operating leases and capital leases (FASB, 1976). For the lessor, there are three types of leases: operating leases, direct financing leases, and sales type leases (FASB, 1976). Direct financing leases and sales type leases from the lessor’s point of view are equivalent to a capital lease for the lessee.
Lessee

The lessee is the firm that has possession of the leased property and makes lease payments throughout the lease term. The lessee can classify a lease as either a capital lease or an operating lease. A lease can be classified as a capital lease from the lessee’s point of view if it is non-cancelable and at least one of four criteria is met. The criteria include (FASB, 1976):

1. Title Transfer – the title for the leased asset transfers to the lessee at the end of the lease term
2. Bargain Purchase Option (BPO) – the lessee has the option to buy the leased asset at the end of the lease term for a bargain price, meaning the lessee can purchase the leased asset for an amount substantially below the expected fair value of the asset at the end of the lease term
3. 75% Economic Life Test – the lease term is equal to or greater than 75% of the estimated economic life of the leased asset

4. 90% Present Value Test – the present value of the minimum lease payments is equal to or greater than 90% of the fair value of the leased asset at the date of the lease’s inception

If none of these criteria are met, the lease is considered an operating lease for the lessee.

Figure 5: Lease Classification Decision Tree

Source: FASB (1976)
Design: Hanauer (2010)
**Operating Lease**

If a lease is classified as an operating lease, the leased assets (i.e. property, plant, & equipment) and the related liability are not reported on the financial statements of the lessee. The lessee would only record the lease payments.

For example, Company T (lessor) leased a building that originally cost $1,000,000 to Company R (lessee) for 5 years, as of December 31, 2010. The building’s estimated economic life is 45 years. The lessee pays first and last month’s lease payments at the inception of the lease, along with a $5,000 deposit. Lease payments are made every month in the amount of $5,000 and the title of the leased asset does not transfer to Company R at the end of the lease term.

First, the lessee would need to determine if any of the following criteria are met.

1. **Title Transfer** – in this scenario, the title of the leased asset does not transfer to the lessee at the end of the lease term, therefore, this criterion is not met.

2. **BPO** – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

3. **75% Economic Life Test** – the lease term of 5 years divided by the estimated economic life of the asset, which is 45 years, equals 11%. This is below 75%, so this test is not satisfied.
4. 90% Present Value Test – the present value of the annual lease payments is $300,000 ($5,000 X 60). $300,000 divided by the fair value of the leased building ($1,000,000) equals 30%. Since this number is under 90%, this test is not satisfied.

Since none of the above criteria are met, the lease is classified as an operating lease from the lessee’s perspective. Throughout the term of the lease, the lessee would need to make the following journal entries:

**Inception of the lease**

At inception, the lessee would need to record any lease payments and the security deposit made as an asset. Additionally, it would record the cash outlay for the payments.

- Prepaid Rent 10,000
- Rent Deposit 5,000
- Cash 15,000

**Adjusting entries**

Adjusting entries need to be made at year end (December 31, 2011) to reduce the asset (prepaid rent) as the rent expense is incurred by the lessee. Rent expense is calculated as $60,000 ($5,000 X 12 months).

- Rent Expense 60,000
  - Prepaid Rent 60,000

These entries would flow through to the income statement as rent expense. The lessee would record the initial security deposit and lease payment on its balance
sheet as assets, reducing the balance in prepaid rent as the payments are earned by the lessor.

**Capital Lease**

If a lease is classified as a capital lease, the leased assets and lease obligation are reported on the balance sheet of the lessee. The leased asset is depreciated over the leased assets useful life if the title transfers or there is a bargain purchase option, otherwise the leased asset is depreciated over the lease term.

For example, Company T (lessor) leased a machine that originally cost $250,000 to Company R (lessee) for 5 years, as of December 31, 2010. The estimated economic life of the leased asset is 7 years, after which the leased asset will be worth $19,000. The residual value of the asset at the end of the lease term is $25,000. The title of the leased asset transfers to Company R at the end of the lease term and the implicit rate of the lease is 10%.

First, the lessee would need to determine if any of the following criteria are met.

1. Title Transfer – in this scenario, the title of the leased asset transfers to the lessee at the end of the lease term, therefore, this criterion is met.
2. BPO – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.
3. 75% Economic Life Test – the lease term of 5 years divided by the estimated economic life of the asset, which is 7 years, equals 71.4%. This is below 75%, so this test is not satisfied.
4. 90% Present Value Test – the present value of the annual lease payments (ALP) is $250,000 ($59,954 X 4.16986). The annual lease payment is calculated by dividing the total amount of the leased asset ($250,000) by 4.16986, which is the present value of an annuity due for 5 years at rate of 10%. $250,000 divided by the fair value of the leased asset ($250,000) equals 100%. Since this number is over 90%, this test is satisfied.

Since at least one of the above criteria is met, the lease is classified as a capital lease for the lessee. Throughout the term of the lease, the lessee would need to make the following journal entries:

_Inception of the lease_

At the inception of the lease, the lessee would put the leased asset on the books and record the accompanying liability for the lease payments. The amount recorded for the capital lease obligation is equal to the present value of the minimum lease payments (MLP), which equals $250,000 as calculated above.

Leased Asset 250,000
Capital Lease Obligation 250,000 (PV of the MLP)

_1st lease payment_

When the first lease payment is made the liability would be reduced and the lessee would record the cash outlay. Typically, the first lease payment is made at the inception of the lease, so the entire payment goes towards the principle because no interest is due yet. The amount recorded is equal to the annual lease payment as calculated above.
2nd lease payment

When the second lease payment is made, the lessee would make the same entry, but would need to factor in any interest due. Interest expense is equal to the balance in capital lease obligation multiplied by the implicit rate. In this case, the balance in capital lease obligation is $190,046 (the original amount of the obligation of $250,000 less the first lease payment of $59,954). Therefore, the interest expense is $19,005 ($190,046 x .10). This leaves a balance of $149,722 in capital lease obligation after the second lease payment and interest have been paid [$190,046 – ($59,954 – $19,005)]. Subsequent lease payments would be recorded in a similar manner, using the balance in capital lease obligation at the time of the payment to calculate the amount of interest due.

\[
\begin{align*}
\text{Capital Lease Obligation} & \quad 40,949 \\
\text{Interest Expense} & \quad 19,005 \\
\text{Cash} & \quad 59,954
\end{align*}
\]

Adjusting Entries

Since the leased asset is reported by the lessee, the lessee would need to record any related depreciation. The depreciation is calculated by subtracting the residual value of the leased asset at the end of the lease term from the original value of the asset, divided by the lease assets estimated economic life of 7 years [($250,000 – $19,000) / 7]. In this case, the assets estimated economic life is used to calculate
depreciation expense instead of the lease term because the title transfers to the lessee at the end of the lease.

<table>
<thead>
<tr>
<th>Depreciation Expense</th>
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<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>33,000</td>
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The leased asset and the capital lease obligation would be recorded on the lessee’s balance sheet and the income statement would show expenses related to the depreciation of the leased asset and interest paid on the capital lease payments.

From the lessee’s point of view, operating leases are more beneficial because they don’t require the leased asset to be reported on the balance sheet. Therefore, the lessee doesn’t have to record any depreciation expense, maintenance and repairs, etc. related to the leased asset. Having to record the leased asset and liability on the financial statements increases the debt to equity ratio, because debt is increased with no change to equity. Recording the leased asset and lease obligation would also lower the current ratio and quick ratio, because the current portion of the capital lease obligation would be factored into these ratios, whereas the leased asset would be considered long-term.

**Lessor**

On the other side of the transaction, the lessor can classify a lease as an operating lease, a direct financing lease, or a sales type lease. The lessor is the firm that leases the asset to another firm in return for periodic payments throughout the lease term. In order to classify a lease as a direct financing lease or a sales type lease, at least one of the four
criteria mentioned previously (Title Transfer, BPO, 75% Economic Life, 90% Present Value) has to be met along with both of the following criteria (FASB, 1976):

1. **Realization Test** – The collectability of the lease payments can be reasonably predicted; and

2. **Earnings Process is Complete** – There are no uncertainties regarding non-reimbursable costs yet to be incurred by the lessor.

If one of these two criteria is not met, the lease is classified as an operating lease.

**Operating Lease**

Under an operating lease, the lessor would report the leased asset and depreciate it over its useful life. The lessor is responsible for repairs and maintenance, as well as property taxes, executor costs, etc. since it still owns the leased asset.

For example, Company T (lessor) leased a building that originally cost $1,000,000 to Company R (lessee) for 5 years, as of December 31, 2010. The lessee pays first and last month’s lease payments at the inception of the lease, along with a $5,000 security deposit. Lease payments are made every month in the amount of $5,000. Repair and maintenance costs associated with the asset were $10,000 and the lessor paid property tax of $10,000. The building’s estimated economic life is 45 years and the title of the leased asset does not transfer to Company R at the end of the lease term.
First, the lessor would need to determine if any of the following criteria are met.

1. Title Transfer – in this scenario, the title of the leased asset does not transfer to the lessee at the end of the lease term, therefore, this criterion is not met.

2. BPO – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

3. 75% Economic Life Test – the lease term of 5 years divided by the estimated economic life of the asset, which is 45 years, equals 11%. This is below 75%, so this test is not satisfied.

4. 90% Present Value Test – the present value of the annual lease payments is $300,000 ($5,000 X 60). $300,000 divided by the fair value of the leased building ($1,000,000) equals 30%. Since this number is under 90%, this test is not satisfied.

Since none of the above criteria are met, the lease is classified as an operating lease from the lessor’s perspective. Throughout the term of the lease, the lessor would need to make the following journal entries:

**Inception of the lease**

At the inception of the lease, the lessor would record a liability for the lease payments and deposits received, but not yet earned. In this case, the lessee paid first and last month’s rent of $10,000 and a security deposit of $5,000.
Subsequent payments received

The lessor would make a similar entry, recording a liability for payments received before they are earned. In this case, the firm would record $60,000 as unearned revenue ($5,000 x 12 months).

Cash 60,000
Unearned Revenue 60,000

Repairs, maintenance and other ownership costs

The lessor would record an expense for any repairs, maintenance, property taxes, and other executor costs related to the leased asset.

Repairs/Maintenance Expense 10,000
Property Tax Expense 10,000
Cash 20,000

Adjusting entries

At year end, the lessor would make an adjustment for revenue that has been both realized and earned over the period, as well as, an adjustment for depreciation on the leased asset ($1,000,000 / 45 years).

Uncarried Revenue 60,000
Rent Revenue 60,000
Depreciation Expense 22,222
Accumulated Depreciation 22,222
On the income statement, the lessor would report the rent revenue, as well as expenses for repairs and maintenance, property taxes, and depreciation. On the balance sheet, it would report the leased asset, accumulated depreciation, unearned revenue, and a liability for the security deposit.

**Direct Financing Lease**

Once a lease has met the requirements to be classified as a direct financing lease or a sales type lease, the objective of the lease needs to be considered in order to distinguish between the two. In a direct financing lease, the lessor expects to recover its original investment and earn interest.

For example, Company T (lessor) leased a machine that originally cost $250,000 to Company R (lessee) for 5 years, as of December 31, 2010. The estimated economic life of the leased asset is 7 years, after which the leased asset will be worth $19,000. The residual value of the asset at the end of the lease term is $25,000. The title of the leased asset transfers to Company R at the end of the lease term and the implicit rate of the lease is 10%. The collectability of the lease payments can be reasonably predicted and there are no uncertainties regarding non-reimbursable costs yet to be incurred by the lessor. The lessor intends to recoup its investment and earn interest.

First, the lessor would need to determine if any of the following criteria are met.

1. **Title Transfer** – in this scenario, the title of the leased asset transfers to the lessee at the end of the lease term, therefore, this criterion is met.
2. **BPO** – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

3. **75% Economic Life Test** – the lease term of 5 years divided by the estimated economic life of the asset, which is 7 years, equals 71.4%. This is below 75%, so this test is not satisfied.

4. **90% Present Value Test** – the present value of the annual lease payments is $250,000 ($59,954 \times 4.16986). $250,000 divided by the fair value of the leased asset ($250,000) equals 100%. Since this number is over 90%, this test is satisfied.

Since at least one of the above criteria is met, the lease can be classified as either a direct financing lease or a sales type lease by the lessor, if both of the following are met:

1. **Realization Test** – The collectability of the lease payments can be reasonably predicted.

2. **Earnings Process is Complete** – There are no uncertainties regarding non-reimbursable costs yet to be incurred by the lessor.

Since both of these are met, the lease is classified based on what the objective of the lessor is. In this case, the lessor wants to recoup its investment, along with interest on the investment. Therefore, the lessor would classify the lease as a direct financing lease. Throughout the term of the lease, the lessor would need to make the following journal entries:
Inception of the lease

At the inception of the lease, the lessor would record a receivable for future expected lease payments and unearned revenue for future interest payments to be received, which is a contra account for lease payments receivable. Under a direct financing lease, the leased asset is not reported in the financial statements, so the lessor would credit the leased asset. Lease payments receivable is equal to the lessor’s gross investment in the lease ($59,954 x 5) and unearned interest revenue equals the difference between the receivable and the carrying value of the leased asset ($299,770 – $250,000).

<table>
<thead>
<tr>
<th>Lease Payments Receivable</th>
<th>299,770</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>250,000</td>
</tr>
<tr>
<td>Unearned Interest Revenue</td>
<td>49,770</td>
</tr>
</tbody>
</table>

Receipt of 1st payment

When the first lease payment is received, the lease payment receivable would be reduced by the amount of the payment. Interest would not be recorded at this point because it has not been earned yet.

<table>
<thead>
<tr>
<th>Cash</th>
<th>59,954</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Payments Receivable</td>
<td>59,954</td>
</tr>
</tbody>
</table>

Receipt of 2nd payment

When the second payment is received, the same entry is made, but unearned interest revenue needs to be reclassified as revenue, since it has been both realized and earned. Interest is calculated as $190,046 (the balance in capital lease
obligation, as previously calculated) multiplied by the implicit rate of 10%.

Therefore, the interest revenue equals $19,005 ($190,046 x .10).

\[
\begin{align*}
\text{Cash} & \quad 59,954 \\
\text{Unearned Interest Revenue} & \quad 19,005 \\
\text{Lease Payments Receivable} & \quad 59,954 \\
\text{Interest Revenue} & \quad 19,005
\end{align*}
\]

On the lessor's balance sheet, a portion of the net investment in the direct financing lease would be recorded under current assets, while the rest is reported under long-term assets. The current portion includes lease payments received and interest revenue earned during the period, whereas the long-term portion includes the entire net investment less payments received and interest earned during the period. The lessor would report interest revenue on the income statement.

**Sales Type Lease**

Contrary to a direct financing lease, if all requirements are met, a lease is considered a sales type lease if the lessor intends to sell the leases asset for a profit, recover its investment, and earn interest. Therefore, the lessor must recognize gross profit at the inception of the lease, as well as interest revenue throughout the term of the lease (FASB, 2009). Using the information from the previous direct financing lease example, under a sales type lease, the lessor would record the following journal entries, throughout the term of the lease:
Inception of the lease

At the inception of the lease, the lessor would record a receivable for the future lease payments to be received, sales revenue, and unearned interest revenue. They would also need to remove the leased asset from inventory (assume the cost of manufacturing the asset was $190,000). Lease payments receivable and unearned interest revenue are calculated in the same manner, but the asset is treated as inventory under a sales type lease. Therefore, sales is credited for the value of the leased asset rather than taking the asset off the books.

<table>
<thead>
<tr>
<th>Lease Payments Receivable</th>
<th>299,770</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>250,000</td>
</tr>
<tr>
<td>Unearned Interest Revenue</td>
<td>49,770</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>190,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>190,000</td>
</tr>
</tbody>
</table>

1st payment received

The first payment is recorded in the same manner. The receivable is reduced by the amount of the lease payment received and no interest is recognized at this point.

<table>
<thead>
<tr>
<th>Cash</th>
<th>59,954</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Payments Receivable</td>
<td>59,954</td>
</tr>
</tbody>
</table>

2nd payment received

When the second payment is received, lease payments receivable is reduced by the amount of the lease payment received and interest revenue is reduced by the amount of interest earned. The calculations are the same as before.
Cash 59,954
Unearned Interest Revenue 19,005
Lease Payments Receivable 59,954
Interest Revenue 19,005

Under a sales type lease, gross profit (sales minus cost of goods sold) and interest revenue are reported on the income statement, with the sale, while lease payments receivable, netted with unearned interest revenue, would be reported on the balance sheet.

IFRS

Unlike U.S. GAAP, IFRS has two types of leases, operating leases and finance leases (Fay, Brozovsky, Edmonds, Lobingier, & Hicks, 2008, 74). Both the lessee and the lessor can classify leases as either type. The finance lease is comparable to a capital lease under U.S. GAAP (Fay et al., 2008, 74). IFRS builds off of the original four criteria (Title Transfer, BPO, Economic Life Test, and Present Value Test) used to determine if a lease is a capital lease under U.S. GAAP.

**Figure 6: IFRS: Types of Leases**

<table>
<thead>
<tr>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating</td>
<td>Operating</td>
</tr>
<tr>
<td>Finance</td>
<td>Finance</td>
</tr>
</tbody>
</table>

Source: Fay et al. (2008)
Design: Hanauer (2010)
To be considered a finance lease, one of the following criteria must be met (Fay et. al., 2008, 74):

1. Ownership transfers to the lessee at the end of the lease term
2. There is a bargain purchase option at the end of the lease term
3. The lease term is for a major part of the asset’s estimated economic life
4. The present value of minimum lease payments amount to substantially all of the fair value of leased assets at the inception of the lease
5. The leased assets are of specialized nature and utilized only by the lessee

If none of these criteria are met, the lease is classified as an operating lease for both the lessee and the lessor.

**Operating Lease**

Accounting for an operating lease under IFRS and U.S. GAAP are very similar, because the risks of ownership do not transfer over to the lessee (IASB, 2009). As a result, the lessee does not record the asset, liability, and related depreciation, but the lessor does.

**Lessee**

For an operating lease the lessee simply recognizes lease payments as an expense over the lease term. Similar to U.S GAAP, the lessee would need to determine if any of the criteria mentioned above have been satisfied. Consider the previous example for an operating lease under U.S. GAAP.

Company T (lessee) leased a building that originally cost $1,000,000 to Company R (lessee) for 5 years, as of December 31, 2010. The building’s estimated economic life is 45 years. The lessee pays first and last month’s lease payments at
the inception of the lease, along with a $5,000 deposit. Lease payments are made every month in the amount of $5,000 and the title of the leased asset does not transfer to Company R at the end of the lease term.

First, the lessee would need to determine if any of the following criteria are met.

1. Title Transfer – in this scenario, the title of the leased asset does not transfer to the lessee at the end of the lease term, therefore, this criterion is not met.

2. BPO – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

3. Economic Life Test – the lease term of 5 years divided by the estimated economic life of the leased asset, which is 45 years, equals 11%. This is well below a major portion of the estimated economic life of the leased asset, so this test is not satisfied.

4. Present Value Test – the present value of the annual lease payments is $300,000 ($5,000 X 60). $300,000 divided by the fair value of the leased building ($1,000,000) equals 30%. Since this number doesn’t account for a substantial portion of the fair value of the leased asset, this test is not satisfied.

5. The leased asset is not of a specialized nature and utilized only by the lessee.
Since none of these criteria are met, the lessee would classify the lease as an operating lease and make the following entries periodically throughout the lease term:

*Inception of the lease*

At the inception of the lease, the lessee would need to record any initial security deposit and lease payments made as an asset. Additionally, they would record the cash outlay for the payments.

- **Prepaid Rent**: 10,000
- **Security Deposit**: 5,000
- **Cash**: 15,000

*Adjusting entries*

Under an operating lease, the lessee records lease payments as an expense recognized on a straight-line basis over the lease term (IASB, 2009). Therefore, adjusting entries need to be made throughout the term of the lease to reduce the asset (prepaid rent) as the rent expense is incurred by the lessee. As calculated under U.S. GAAP, the expense would equal $60,000 ($5,000 x 12 months).

- **Rent Expense**: 60,000
- **Prepaid Rent**: 60,000

The leased asset would not be recorded on the statement of financial position (balance sheet), but the lessee would record the initial lease payment as an asset, reducing it over the term of the lease as the payments are earned by the lessor.
(KPMG, 2010). Rent expense would be recorded on the statement of comprehensive income (KPMG, 2010).

**Lessor**

Under an operating lease, the lessor reports the leased asset in its financial statements and is responsible for any expenses related to maintenance, repairs, depreciation, etc. (IASB, 2009). Consider the previous operating lease example under U.S. GAAP:

Company T (lessor) leased a building that originally cost $1,000,000 to Company R (lessee) for 5 years, as of December 31, 2010. The building’s estimated economic life is 45 years. The lessee and last month’s lease payments at the inception of the lease, along with a $5,000 deposit. Lease payments are made every month in the amount of $5,000. Repair and maintenance costs associated with the asset were $10,000 and the lessor paid property tax of $10,000. The title of the leased asset does not transfer to Company R at the end of the lease term.

First, the lessor would determine if any of the following criteria are met.

1. **Title Transfer** – in this scenario, the title of the leased asset does not transfer to the lessee at the end of the lease term, therefore, this criterion is not met.

2. **BPO** – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.
3. Economic Life Test – the lease term of 5 years divided by the estimated economic life of the asset, which is 45 years, equals 11%. This is well below a major portion of the estimated economic life of the leased asset, so this test is not satisfied.

4. Present Value Test – the present value of the annual lease payments is $300,000 ($5,000 X 60). $300,000 divided by the fair value of the leased building ($1,000,000) equals 30%. Since this number doesn’t account for a substantial portion of the fair value of the leased asset, this test is not satisfied.

5. The leased asset is not of a specialized nature and utilized only by the lessee.

Since none of the above criteria are met, the lease is classified as an operating lease from the lessor’s perspective. Throughout the term of the lease, the lessor would make the following journal entries:

**Inception of the lease**

At the inception of the lease, the lessor would record unearned revenue related to payments and deposits received similar to the way it is recorded under U.S. GAAP.

<table>
<thead>
<tr>
<th>Cash</th>
<th>15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned Revenue</td>
<td>10,000</td>
</tr>
<tr>
<td>Deposit Liability</td>
<td>5,000</td>
</tr>
</tbody>
</table>
Lease payments received

A liability for the lease payments received, but not earned is recorded. Revenue is calculated in the same manner under both sets of standards ($5,000 x 12 months).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>60,000</td>
</tr>
<tr>
<td>Unearned Revenue</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Repairs and Maintenance

The lessor would record any expenses related to the leased asset (repairs, maintenance, executor, etc.).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Repairs/Maintenance Expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Property Tax Expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Adjusting entries

The income from the lease payments is recognized on a straight-line basis over the lease term and depreciation expense is recorded (IASB, 2009). Depreciation is expensed over the estimated economic life of the asset ($1,000,000 / 45 years).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned Revenue</td>
<td>60,000</td>
</tr>
<tr>
<td>Rent Revenue</td>
<td>60,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>22,222</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>22,222</td>
</tr>
</tbody>
</table>

The lessor would report the leased asset in the statement of financial position, and report rental revenue, depreciation, and other asset related expenses on the statement of comprehensive income (KPMG, 2010). The lessor adds any initial direct costs to the carrying amount of the leased asset and recognizes the expense
on a straight-line basis over the lease term (Deloitte, IFRS’s in Your Pocket, 2009, 64).

**Finance Lease**

A finance lease transfers substantially all risks and rewards of ownership to the lessee (IASB, 2009). Even if a lease is classified as an operating lease at its inception, IFRS specifies three criteria that, if met, would allow the lessee or the lessor to reclassify the lease as a finance lease (Fay et al., 2008). The criteria include (Fay et al., 2008):

1. The lessee is responsible for the lessor’s losses, if they terminate the lease early.
2. The lessee is responsible for any gains and losses due to fluctuation in the residual fair value of the leased asset (Gross Residual Value).
3. The lessee has the option to extend the lease for less than the market rate (BPO).

**Lessee**

In the lessee’s statement of financial position, the interest rate implicit in the lease is used to calculate the minimum lease payments, and indirect costs associated with the leased asset are included in the carrying value of asset (IASB, 2009). Consider the previous capital lease example under U.S. GAAP:

Company T (lessor) leased a machine that originally cost $250,000 to Company R (lessee) for 5 years, as of December 31, 2010. The estimated economic life of the leased asset is 7 years, after which the leased asset will be worth $19,000. The residual value of the asset at the end of the lease term is $25,000. The title of the leased asset transfers to Company R at the end of the lease term and the implicit rate of the lease is 10%.
First, the lessee would need to determine if any of the following criteria are met.

1. Title Transfer – in this scenario, the title of the leased asset transfers to the lessee at the end of the lease term, therefore, this criterion is met.

2. BPO – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

3. Economic Life Test – the lease term of 5 years divided by the estimated economic life of the asset, which is 7 years, equals 71.4%. Determining if this test is met requires more judgment than under U.S. GAAP. In this case, assume that 71.4% is a major portion of the estimated economic life of the leased asset, so this test is satisfied.

4. Present Value Test – the present value of the annual lease payments is $250,000 ($59,954 X 4.16986). $250,000 divided by the fair value of the leased asset ($250,000) equals 100%. Since this number accounts for a substantial portion of the fair value of the leased asset, this test is satisfied.

   The annual lease payment is calculated by dividing the total amount of the leased asset ($250,000) by 4.16986, which is the present value of an annuity due for 5 years at 10%.

5. The leased asset is not of a specialized nature and utilized only by the lessee.

Since at least one of the above criteria is met, the lease is classified as a finance lease for the lessee. Throughout the term of the lease, the lessee would record the following journal entries:
Inception of the lease

At the inception of the lease, the lessee would record the leased asset and the accompanying liability for the lease payments.

Leased Asset 250,000
Lease Liability 250,000

1st lease payment

Similar to U.S. GAAP, when the first lease payment is made the liability would be reduced and the lessee would record the cash outlay. The first payment typically goes entirely towards principle, because it is made at the inception of the lease before any interest has been incurred.

Lease Liability 59,954
Cash 59,954

2nd lease payment

When the second lease payment is made, the lessee would make the same entry, but would factor in any interest due for the period. Rather than debiting interest expense, the lessee would debit finance expense. Finance expense is calculated similar to interest expense under U.S. GAAP.

Lease Liability 40,949
Finance Expense (Interest Expense) 19,005
Cash 59,954

Adjusting Entries

Since the leased asset is reported on the balance sheet of the lessee, the lessee would need to record any related depreciation. In this case, the depreciation is
calculated by subtracting the residual value of the leased asset at the end of the lease term from the original value of the asset, divided by the estimated economic life of the leased asset \[ (\frac{$250,000 - $19,000}{7 \text{ years}}) \].

\[
\begin{align*}
\text{Depreciation Expense} & \quad 33,000 \\
\text{Accumulated Depreciation} & \quad 33,000
\end{align*}
\]

The lessee recognizes the leased asset and related liability on its statement of financial position at the lower of the fair value of the leased asset at the inception of the lease or the present value of the minimum lease payments (IASB, 2009). On the statement of comprehensive income, the lessee would report depreciation related to the leased asset and finance expense (KPMG, 2010). Similar to U.S. GAAP, the recognition of the leased asset and the related liability on the statement of financial position have an unfavorable impact on the debt to equity ratio, the current ratio, and the quick ratio, because debt and current liabilities increase, while equity and current assets remain the same.

**Lessor**

All leases classified as direct financing leases or sales type leases under U.S. GAAP would be classified as a finance lease under IFRS. Under a finance lease, the lessor is not required to report the leased asset on its financial statements because all of the risks of ownership transfer to the lessee. Therefore the lessee would report the asset on its financial statements. By classifying leases this way rather than separating them based on the purpose of the lease, IFRS ensures that all leased assets are reported on the statement of financial position of at least on party. Consider the previous direct financing lease under U.S. GAAP:
Company T (lessor) leased a machine that originally cost $250,000 to Company R (lessee) for 5 years, as of December 31, 2010. The estimated economic life of the leased asset is 7 years, after which the leased asset will be worth $19,000. The residual value of the asset at the end of the lease term is $25,000. The title of the leased asset transfers to Company R at the end of the lease term and the implicit rate of the lease is 10%. The collectability of the lease payments can be reasonably predicted and there are no uncertainties regarding non-reimbursable costs yet to be incurred by the lessor.

First, the lessor would need to determine if any of the following criteria are met.

1. Title Transfer – in this scenario, the title of the leased asset transfers to the lessee at the end of the lease term, therefore, this criterion is met.

2. BPO – there is no option to buy the leased asset for an amount substantially below the asset’s fair value at the end of the lease term, therefore, this criterion is not met.

6. Economic Life Test – the lease term of 5 years divided by the estimated economic life of the asset, which is 7 years, equals 71.4%. Since this test requires more judgment, assume that 71.4% is a major portion of the estimated economic life of the leased asset. This test is satisfied.

3. Present Value Test – the present value of the annual lease payments is $250,000 ($59,954 X 4.16986). $250,000 divided by the fair value of the leased asset ($250,000) equals 100%. Since this number accounts for a substantial portion of the fair value of the leased asset, this test is satisfied.
4. The leased asset is not of a specialized nature and utilized only by the lessee.

Since at least one of the above criteria is met, the lease is classified as a finance lease for the lessor. Contrary to U.S. GAAP, the lease classification does not depend on the lessor's objective in the lease. Under a finance lease, the lessor would record the following journal entries throughout the term of the lease:

**Inception of the lease**

At the inception of the lease, the leased asset is taken off of the books of the lessor and a receivable is recognized for the lease payments to be received (Marshall, 2004, 93). The entry resembles that of a lessor under a direct financing lease.

\[
\begin{align*}
\text{Finance Lease Receivable} & \quad 299,770 \\
\text{Asset} & \quad 250,000 \\
\text{Unearned Interest Revenue} & \quad 49,770
\end{align*}
\]

Lessors in the manufacturing business would recognize the selling profit/loss the same way they would recognize a sale (Deloitte, IFRS’s in Your Pocket, 2009, 64). Any cost related to the asset would then be expensed as the profit is realized (IASB, 2009). This entry is similar to that of a lessor under a sales type lease.

\[
\begin{align*}
\text{Finance Lease Receivable} & \quad 299,770 \\
\text{Sales} & \quad 250,000 \\
\text{Unearned Interest Revenue} & \quad 49,770 \\
\text{Cost of Goods Sold} & \quad 190,000 \\
\text{Inventory} & \quad 190,000
\end{align*}
\]
Receipt of 1st payment

Upon receipt of the first lease payment, the lessor reduces the amount of the receivable without recognizing interest, because there is no interest due at this point.

<table>
<thead>
<tr>
<th>Cash</th>
<th>59,954</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance Lease Receivable</td>
<td>59,954</td>
</tr>
</tbody>
</table>

Receipt of 2nd payment

The second lease payment is recorded in a similar manner, but interest revenue is factored in. Interest revenue is calculated the same as under U.S. GAAP.

<table>
<thead>
<tr>
<th>Cash</th>
<th>59,954</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned Interest Revenue</td>
<td>19,005</td>
</tr>
<tr>
<td>Finance Lease Receivable</td>
<td>59,954</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>19,005</td>
</tr>
</tbody>
</table>

On the statement of financial position, the lessor would report the finance lease receivable at the amount of the lessor’s net investment in the lease (IASB, 2009).

On the statement of comprehensive income, the lessor would report interest revenue and any profit on the sale (KPMG, 2010). The lessor would add any direct costs to the carrying value of leased asset and expense them over the term of the lease (Deloitte, IFRS’s in Your Pocket, 2009, 64).

Similarities/Differences

One of the major differences between accounting for leases under IFRS versus U.S. GAAP is that IFRS has two types of leases that can be used by either the lessee or the lessor, whereas U.S. GAAP has two for the lessee and three for the lessor. Rather than
having a capital lease, IFRS has a finance lease that encompasses leases that would be considered direct financing or sales type leases under U.S. GAAP. This is due to timing differences regarding the recognition of gains and losses for the lessee and the lessor under U.S. GAAP that allow both parties to classify the lease differently (Langmead & Soroosh, 2009, 23).

Additionally, U.S. GAAP provides more written guidance than IFRS, mainly because it has been around for so long (Langmead & Soroosh, 2009, 21). Therefore U.S. GAAP is more detailed and complex, while IFRS is more general and requires more judgment when applying standards (Langmead & Soroosh, 2009, 22). This can lead to inconsistency in the way IFRS are interpreted and applied from country to country. U.S. GAAP provides specific measurements to follow rather than broad terms, like IFRS (Langmead & Soroosh, 2009, 20). The lease classification criteria read as follows:
IFRS uses terms like "major part" and "substantially all" to describe amounts that U.S. GAAP gives specific percentages for. Determining the proper amounts requires more judgment under IFRS. IFRS also provides more criteria for classifying leases, giving five criteria rather than four, and allows for an operating lease to be reclassified as a finance lease if certain conditions are met, which is not the case under U.S. GAAP.

Another major difference regarding leases is that IFRS considers land and buildings separately when classifying a lease. The land portion of a leased asset is classified as an operating lease unless the title transfers to the lessee at the end of the lease term, whereas
the building portion follows the five criteria provided to classify a lease as a finance lease (Marshall, 2004, 93). Lease payments are then divided between the operating lease component for land and finance lease component for the building (Marshall, 2004, 93).

### Table 1: Similarities/Differences

<table>
<thead>
<tr>
<th>Similarities/ Differences</th>
<th>U.S. GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Leases</strong></td>
<td>2 for the lessee</td>
<td>2 for both</td>
</tr>
<tr>
<td>Types of Leases for the Lessee</td>
<td>Operating and capital</td>
<td>Operating and finance</td>
</tr>
<tr>
<td>Types of Leases for the Lessor</td>
<td>Operating, direct financing, and sales type</td>
<td>Operating and finance</td>
</tr>
<tr>
<td>Standards</td>
<td>Detailed</td>
<td>Broad</td>
</tr>
<tr>
<td>Number of Lease Criteria</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Economic Life Test</td>
<td>Lease term must be 75% of the economic life of the asset</td>
<td>Lease term must be “major part” of the economic life of the asset</td>
</tr>
<tr>
<td>Present Value Test</td>
<td>PV of MLP is 90% of fair value of the asset</td>
<td>PV of MLP is “Substantially all” of the fair value of the asset</td>
</tr>
<tr>
<td>Additional Criteria</td>
<td>Requires 2 more criteria to be met in order to be classified as direct financing or sales type leases</td>
<td>N/A</td>
</tr>
<tr>
<td>Reclassification Expenses</td>
<td>Not allowed</td>
<td>Lease can be reclassified if 3 criteria are met</td>
</tr>
<tr>
<td>Land/Building Lease</td>
<td>Interest expense</td>
<td>Finance expense</td>
</tr>
<tr>
<td>Lease Classification</td>
<td>Not considered separately</td>
<td>Considered separately</td>
</tr>
<tr>
<td>Operating Leases</td>
<td>Lease Classification depends on the lessor’s objective in the lease</td>
<td>Lease classification depends on whether ownership of the leased asset transfers</td>
</tr>
<tr>
<td></td>
<td>Lessee doesn’t report asset or related expenses</td>
<td>Lessee doesn’t report asset or related expenses</td>
</tr>
<tr>
<td></td>
<td>Lessor reports asset and related expense</td>
<td>Lessor reports asset and related expense</td>
</tr>
<tr>
<td>Overrides</td>
<td>No overrides allowed</td>
<td>true and fair override of standards when necessary for appropriate financial presentation</td>
</tr>
</tbody>
</table>

Design: Hanauer (2010)
Work is currently being done to resolve the major differences in accounting for leases under IFRS and U.S. GAAP, but the standard setting bodies have not determined what changes will be made at this point. The IASB and the FASB plan to have an exposure draft ready for comment by June of 2010, with the final standard being ready for publication by July of 2011 (KPMG, 2010). With the convergence projects well under way, it’s important to be aware of how a more principles based set of financial reporting standards will affect the U.S.

Public Companies

U.S. public companies face a major change in financial reporting standards in the near future. If conversion goes as planned, the U.S. will need to make two major changes: adopt new GAAP standards, and adopt converged IFRS standards (Munter, 2010, 46). Public companies need to start thinking about how this change will impact them. The SEC requires that the past three years of financial statements be presented in the year of transition to IFRS, as well as the current year’s financial statements, whereas, the IASB only requires that the current and previous year be presented. Therefore, companies need to be aware of the changes they will need to make in order to keep track of the historical information required under IFRS that they aren’t currently keeping track of. Companies need to start collecting this data and budget for the costs associated with transitioning now, according to the proposed time line for conversion (Difazio & Gannon, 2009, 128). Since the SEC has recently shown some doubt about whether to convert or converge, many companies are reluctant to invest large amounts of capital into transitioning to IFRS at this point (Leone, 2009). Many are waiting for IFRS to become mandatory.
Procrastinating

Waiting until the last minute to get up to speed on IFRS could be disastrous for a public company, if the SEC decides to move forward with conversion. Many companies don’t understand the extent of the change needed to meet IFRS requirements (Difazio & Gannon, 2009, 121). IFRS will affect many different areas of a company including accounting, financial reporting, internal processes, controls, regulatory and management reporting, technology, tax, treasury, legal and contracts, compensation, human resources, communication, and operations (Difazio & Gannon, 2009, 122). Since the SEC’s presentation requirements create the need to keep historical data under IFRS, companies will need to keep two sets of records in order to comply with both sets of standards up until the initial adoption of IFRS (Langmead & Soroosh, 2009, 23; Deloitte, 2010, 4). This also affects a company’s system requirements, since many companies don’t currently keep track of the historical information required under IFRS (Langmead & Soroosh, 2009, 23). Companies need to develop a plan for transition to avoid problems with their systems. The AICPA has stated that many companies will need at least two years to make the necessary upgrades to track the information needed, after which they will need time to create IFRS frameworks and populate them with historical data (AICPA Supports IFRS Adoption, Recommends Changes to SEC Road Map, 2009; Leone, From GAAP to Global Accounting in Seven Months, 2008). Delaying conversion until the deadline will lead to inefficiency, redundancy, and complexity (Difazio & Gannon, 2009, 121). A successful transition would require at least 3-5 years of preparation (Difazio & Gannon, 2009, 123).
When the European Union converted to IFRS in 2005, it gave companies 3 years to transition (Langmead & Soroosh, 2009, 24). Many companies took their time, leading to problems as the deadline for mandatory conversion approached. Some of the major problems the European Union dealt with include (Langmead & Soroosh, 2009):

1. Companies thought IFRS was mainly an accounting issue
2. Procrastination led to costly delays
3. Significant upgrades to software were needed to capture additional information
4. Companies weren’t able to fully integrate IFRS into their processes and systems
5. Companies focused on getting it done the first year, so they didn’t see benefits right away

U.S. public companies need to consider these issues and take steps to prepare now. While waiting until the last minute can be problematic, “jumping” to IFRS too quickly has implications, as well.

“Jumping”

For global companies with aggressive competition, it may be a good idea to start transitioning now, but for other companies, “jumping” to IFRS may do more harm than good (Difazio & Gannon, 2009, 125). Some companies are ‘jumping’ to IFRS as soon as the SEC will allow, rather than waiting for further action by the SEC (Bunting & Frank, 2008, 6). This could be even more costly for them. Following the proposed roadmap is meant to reduce costs, and increase tax savings during the transition (Difazio & Gannon, 2009, 126). Not to mention the fact that the SEC hasn’t made a definite decision to convert. Training employees too soon without giving them the chance to use the
knowledge could lead to retraining; people may forget what they learned by the time they need to use it (Johnson, Goodbye GAAP, 2008).

The best way to approach this would be to follow the SEC’s proposed timeline. Public companies need to start thinking about the changes that will need to be made and budget for them now, without taking any drastic measures to convert at this point. Whatever the SEC decides to, companies need to communicate with investors, as well as auditors, to ensure that everyone understands the extent of the changes that a principles based set of financial reporting standards will require (Difazio & Gannon, 2009, 125). While it is important for U.S. public companies to be up to speed on the IFRS, most companies don’t have the in house expertise or the means to train employees to this magnitude.

**Accounting Firms**

U.S. accounting firms have a major responsibility to inform the public about IFRS, not just because of the potential conversion in the U.S., but because IFRS is going global whether the U.S. joins in or not. U.S. companies are going to deal with IFRS through their foreign competitors and if they don’t have knowledgeable accountants in house, they are going to turn to accounting firms. This is a major opportunity for firms to assist in the transition and gain clients (Deane & Heilman, 2009). Firms could miss out on a huge source of revenue if they aren’t prepared. When the European Union converted to IFRS in 2005, accounting firms were very involved in the transition process (Langmead & Soroosh, 2009, 24). Similarly, any conversion or convergence in the U.S. is going to require assistance from accounting firms. Some companies are being acquired by foreign owners and are required to convert, while others want to know how the proposed conversion will affect them (Bunting & Frank, 2008, 6). Typically it is larger...
firms, who bring in more revenue for the firm, asking for information, and being unprepared could cost them these clients (Bunting & Frank, 2008, 6). In order to prepare for the onslaught of clients wanting information about IFRS, accounting firms need to properly train their employees. Training will be costly because so few have any significant knowledge about IFRS. According to a recent survey conducted by the AICPA in 2009, 22% of CPAs have no knowledge of IFRS, while 42% of CPAs have a basic knowledge (CPAs Becoming More Familiar with IFRS, Many Want More Time, 2009). While training these employees will be costly, it will be beneficial in the long run. Being aware of the differences between IFRS and U.S. GAAP is crucial for accounting firms; it’s important to train employees and invest in education to ensure IFRS knowledge is maintained.

Education

What steps need to be taken to ensure that the next generation of CPAs is prepared for both the CPA exam and working in the real world? The U.S. needs to consider how the transition to a more principle based set of financial reporting standards is going to affect the education system and the content of the Uniform CPA Exam. Currently, IFRS isn’t taught to a large extent in universities, mainly because it isn’t currently being covered on the CPA exam. So, who is responsible for educating future accountants about IFRS in the interim period between when IFRS material is covered on the CPA exam and when it is taught in universities? We need to focus on integrating IFRS into the educational system now in order to ensure that current accounting majors will be prepared for the transition to a more principles based set of financial reporting standards.
**Firms**

The Big Four accounting firms have taken significant measures to provide information about IFRS to their clients, interns, employees, etc. In fact, they seem to be competing “over who will do the most to help the educational system, and corporate clients,” according to Roy Harris in an article for *CFO Magazine* (2008). The Big Four have created their own IFRS universities, including Deloitte’s “University Consortium,” Ernst & Young’s “Academic Resource Center,” KPMG’s “IFRS Institute,” and PricewaterhouseCoopers “PWC university.” These universities contain complete IFRS course materials that professors can utilize to create a better understanding among students of the major differences between U.S. GAAP and IFRS (Harris, 2008). Even smaller firms have taken similar measures to educate their workforce and clients, through “self-study programs” (Harris, 2008). This is a big step towards increasing the knowledge of IFRS, especially in the classroom, where there isn’t a lot of information available for professors to use. Many professors make up their own course materials, if they want to discuss IFRS in their classes.

IFRS universities aren’t the only way to educate the future workforce; many large firms have begun to integrate IFRS into their internship programs, as well (Nilsen, 2008). This increased effort to increase awareness of IFRS may be due to the fact that the Big Four require some awareness of IFRS in their recruiting process. Awareness of IFRS is becoming more and more important for recruiting in the Big Four; they expect new hires and interns to know the general differences between GAAP and IFRS and the importance of IFRS for the future (Nilsen, 2008). In fact, PWC discusses IFRS during their on-
campus interviews (Kroll, 2009, 53). They also look to recent graduates to inform the rest of their staff about current changes in reporting standards and ways to improve their current processes (Kroll, 2009, 53). While the Big Four are taking on the responsibility of educating the public about IFRS, universities are beginning to realize the extent of the change required.

Universities

Many universities are considering adding IFRS to the curricula for accounting majors (Nilsen, 2008). To date, the extent of IFRS in the classroom is minimal, but professors are taking the initiative to inform their students about the major changes IFRS would bring about. Currently, students can expect a general awareness of IFRS, the IASB, and the convergence efforts from basic level accounting courses, but a broader knowledge is needed if these students are expected to be able to use IFRS in the workforce someday (Nilsen, 2008). Depending on the professor, they may get a more in depth exposure to IFRS in upper level courses, but the coverage varies (Kroll, 2009, 52). There are many things to consider when proposing a change to the current curricula. The table below illustrates these issues.
One of the biggest problems educators face is creating more room in the accounting curricula, without cutting valuable information. How do we determine what to get rid of and replace with IFRS information? Students will need to understand both sets of standards if the SEC goes through with conversion. This will require students to learn a different skill set when applying IFRS, since it involves more judgment (Kroll, 2009, 54). In the end, accounting majors may be required to take more courses, which will increase the workload for students (Kroll, 2009, 54). Not to mention the fact that IFRS materials for the classroom are limited. While the Big Four are taking on the responsibility of informing the public, there aren’t any textbooks that cover IFRS thoroughly (Kroll, 2009). At the most, there may be a discussion page at the end of every chapter (Kroll, 2009).
2009). With limited information about IFRS, many professors aren’t qualified to teach it or don’t want to bother with it (Accounting Educators Say U.S. at Disadvantage Without IFRS, 2009). “Nearly half of accounting faculty at U.S. universities believe the U.S. should transition to IFRS to remain competitive, and three-quarters think IFRS needs to be immediately incorporated into their school’s curricula” (Accounting Educators Say U.S. at Disadvantage Without IFRS, 2009). But few administrators understand the magnitude of change required and are reluctant to make any changes (Accounting Educators Say U.S. at Disadvantage Without IFRS, 2009). Although some professors are making an effort to incorporate IFRS for their students, many universities are waiting for the SEC to make IFRS a requirement before they start making changes to the accounting curricula. It’s important to implement IFRS into the educational system now, but the information covered on the CPA exam is a huge factor in determining what to include in accounting curricula.

**CPA exam**

The Uniform CPA Exam content specifications for 2011 show that IFRS will be tested on the Financial Accounting and Reporting section of the CPA exam starting January of 2011, although to a limited extent (AICPA, 2009). The content specifications show that test takers will need to be able to “identify and understand the differences between financial statements prepared under U.S. GAAP and IFRS,” as well as, financial reporting, presentation, and disclosures in general-purpose financial statements regarding first-time adoption of IFRS (AICPA, 2009). The AICPA is currently developing IFRS questions to be used on the 2011 exam and has held two IFRS item writing workshops that resulted in several hundred new test questions (The Uniform CPA Examination
Alert, 2009). Additional IFRS item writing workshops are planned in 2010, as well. (The Uniform CPA Examination Alert, 2009). With a minimal amount of IFRS information in accounting curricula, the CPA exam may change by the time current students take it, leaving students with a lack of knowledge in IFRS that may still be covered on the exam (Nilsen, 2008). With the exam content driving accounting curricula, those who will be taking the exam in 2011, won’t necessarily have the educational background in IFRS to take the exam. This is an issue that needs to be addressed now, in order to properly prepare accounting students.

Conclusion

Making a transition to IFRS at this point could do more harm than good. The U.S. needs to continue the convergence efforts to ensure that the standards the U.S. follows in the future will be of high-quality. Compromising with a more rules based approach may be beneficial for global accountants to ensure comparability of financial information from country to country. We need to compromise and create a set of standards that involves the good aspects of both principles and rules based standards, not just one or the other. One set of standards is a good idea and is beneficial, but is not something that can be rushed into. We need to take the time to properly prepare, not just our public companies and education system, but the standards as well.
REFERENCES


