

Analysis of Lease Accounting Treatment Under ASC 842 and IFRS 16: A Case Study of Auto Inc. and Trans-Atlantic Inc. Contracts

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Abstract: This memorandum examines the application of ASC 842 and IFRS 16 lease accounting standards to contracts between Auto Inc. and Trans-Atlantic Inc. for the transportation of sedan and luxury cars. The analysis focuses on identifying whether these contracts contain leases by assessing the presence of identifiable assets and the right to control their use. The study concludes that the sedan car contract meets the criteria for a lease under both standards, with MV Manhattan as the identifiable asset and Auto Inc. having control over its use. Conversely, the luxury car contract does not qualify as a lease due to the absence of an identifiable asset and lack of control by Auto Inc. The memorandum also highlights key similarities and differences between ASC 842 and IFRS 16 in lease identification and classification, offering valuable insights for practitioners navigating these accounting frameworks.

Keywords: ASC 842, IFRS 16, Lease accounting, Identifiable asset, Right to control, Sedan car contract, Luxury car contract, Auto Inc., Trans-Atlantic Inc., MV Manhattan, FASB, IASB.

1. ASC 842 Overview

ASC 842 is the new lease accounting standard issued by the FASB. It requires all public and private entities reporting under US GAAP to record the vast majority of their leases on their balance sheets (FASB, n.d.). This standard represents a significant shift from previous accounting rules and is designed to provide more transparency regarding the liabilities stemming from lease contracts. ASC842-10-15-3 defines a lease as a contract that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. When determining whether a contract meets the definition of a lease, there are two key criteria that must be met for an arrangement to constitute a lease:

- (1) There must be an identified asset, and
- (2) The lessee must have the right to control the use of that identified asset during the term of the lease.

1.1. Determining an Identified Asset

Following the terms of the contract for carriage of sedan cars and luxury cars between Auto Inc. and Trans-Atlantic Inc., it is clear that the terms of the sedan car contract included an identified asset, but the terms of the luxury car contract did not. According to ASC842-10-15-4, to determine whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset.

b. The right to direct the use of the identified asset.

Compare them to sedan car contracts, where MV Manhattan is committed to transporting Auto Inc.'s sedan cars in accordance with the terms of the contract. The contract spelled out which European ports Auto Inc. could use to

receive the cargo and the order in which deliveries were made and directed Trans-Atlantic Inc. to follow their schedule (FASB, n.d.). Finally, since Auto Inc. has full control of the MV Manhattan in Trans-Atlantic Inc.'s fleet, they were able to send that ship below capacity without Trans-Atlantic Inc. stacking up other products to ship to Auto Inc. Customers other than. Based on these terms, it is evident that Trans-Atlantic Inc. has provided Auto Inc. with a dedicated vessel - MV Manhattan - for the term of the contract, based on the identifiable fact that Auto Inc. fully controls its car shipments assets (Singer et al., 2023).

When looking at the Luxury Car contract between Auto Inc. and Trans-Atlantic Inc., it is easy to see that the terms of the contract do not indicate the existence of identifiable assets (Enache et al., 2023). The luxury car contract states that Trans-Atlantic Inc. has five weeks to ship the luxury car from Auto Inc., which means that Trans-Atlantic Inc. can decide when to ship the car within those five weeks. Trans-Atlantic Inc. also determined the shipping route used to deliver the cars to Auto Inc. Trans-Atlantic Inc. may select any vessel from its fleet to fulfill the request and has the right to use the product with the option to ship other customers using excess capacity (Cheng et al., 2022). Based on these terms, it is clear that, unlike the sedan contract, the luxury car contract does not include an identifiable asset because the customer, Auto Inc., has no right to direct the use of the asset. ASC842-10-15-9 points out that an asset typically is identified by being explicitly specified in a contract (FASB, n.d.). However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer. However, Auto Inc. does not have a luxury vessel built specifically for its luxury vehicles and cannot be sure when the goods will be delivered, where exactly, or even what ships are waiting at their ports. Not only that, but Trans-Atlantic Inc. was able to use this ship to deliver products to other customers and reduce transportation costs, also does not meet the

conditions implicitly specified (Heese et al., 2023).

1.2. Determining the Right to Control the Use of The Identified Asset

For a lease agreement to be entered into between Auto Inc. and Trans-Atlantic Inc., Auto Inc. must own the right to use the asset. ASC 842-10-15-20 states that a customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:

a. The customer has the right to direct how and for what purpose the asset is used throughout the period of use.

b. The relevant decisions about how and for what purpose the asset is used are predetermined and at least one of the following conditions exists:

(1) The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.

(2) The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

In the case of sedans, Auto Inc. does have the use of identified assets right. MV Manhattan is strictly instructed by Auto Inc. in terms of the number of departures, where to go, and when. Not only that, but Auto Inc. can also control the use of the asset, because the ship cannot be used for other purposes than to transport cars. The supplier, Trans-Atlantic Inc., also may not change the operating instructions for the leased asset (FASB, n.d.). It was a clear finding that, even if it was beneficial to their own company, Trans-Atlantic Inc. could neither use the excess capacity for any other customer nor change the port to which MV Manhattan was heading when MV Manhattan was not particularly full (Gorman et al., 2020).

Turning to contracts for luxury cars, Auto Inc. does not have any identifiable assets. Obviously, if there is no identifiable asset in the first place, then there is no right to control the use of the identifiable asset (Nair, 2024). Even if an identifiable asset exists, Auto Inc. does not have the right to use that asset. As can be seen against ASC 842-10-15-20, Auto Inc. dictates neither how nor for what purpose the asset is to be used in the contract. Trans-Atlantic Inc. reserves the right to use the vessel's excess capacity for any other customer (FASB, n.d.). Not only that, but in order to be able to meet the needs of other customers, Trans-Atlantic Inc. can choose where the goods go. So even if a limousine is needed in one part of Europe, Trans-Atlantic Inc. can deliver the ship to a port in another country (FASB, n.d.). Finally, Trans-Atlantic Inc. also reserves the right to choose when to ship within 5 weeks. To sum up, Auto Inc. does not have control over the assets in the luxury car contract, but it does have control over the assets in the sedan contract (Matouq, 2022).

2. IFRS 16

IFRS 16 has emerged to replace International Accounting Standard (IAS) 17. The approach of IAS 17 is to distinguish between two types of leases (IFRS, n.d.). Leases that transfer substantially all the risks and rewards of ownership of the asset are finance leases, while all other leases are classified as operating leases (IFRS, n.d.). IFRS 16 was then introduced to circumvent the issue that the classification of leases under IAS 17 is subjective (FASB, n.d.). Unlike US GAAP, there are no specific classification criteria since there is only one

type of lease under IFRS 16. US GAAP continues to retain two types of leases under ASC 842 – operating and financial, however IFRS 16 accounts for only one type of lease: finance leases (Aghimien & Matherly, 2021).

IFRS 16 states that a contract is or contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. To assess whether a contract conveys the right to control the use of an identified asset for a period of time, the lessee must have both of the following (IFRS, n.d.):

(1) the right to obtain substantially all of the economic benefits from the use of the identified asset, and

(2) the right to direct the use of the identified asset.

A characteristic of a lease is that the underlying asset is "identifiable". This is usually achieved through assets specified in a contract or part of a contract (FASB, n.d.). For an asset to be identified, the supplier of the asset shall not replace the asset with a substitute asset throughout its lifetime (IFRS, n.d.). The fact that the supplier of an asset has the right or obligation to replace the asset when repairs are required does not preclude the asset from being an "identified asset" (McCallum et al., 2020).

In this case, determining whether the contract between Auto Inc. and Trans-Atlantic Inc. for the carriage of sedan cars and luxury cars contains identified assets is not substantially different under IFRS 16 than under ASC 842 (IFRS, n.d.). MV Manhattan is committed to transporting Auto Inc.'s cars in accordance with the terms of the contract, which is the asset specified in the contract. This means that under IFRS 16 the contract for sedan cars between Auto Inc. and Trans-Atlantic Inc. contains identifiable assets. and when looking at the Luxury Car contract between Auto Inc. and Trans-Atlantic Inc., it is easy to see that the terms of the contract do not indicate the existence of an identifiable asset (Singer et al., 2020). Regarding the right to direct the use of the asset, IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

The customer has the right to direct how and for what purpose the asset is used throughout its period of use; or The relevant decisions about use are pre-determined and the customer has the right to operate the asset throughout the period of use without the supplier having the right to change these operating instructions, or the customer designed the asset in a way that predetermines how and for what purpose the asset will be used (Hunsader et al., 2022).

In this case, the determination under IFRS 16 of whether each contract conveys to the lessee the right to control the use of an identified asset is similar to ASC 842 (IFRS, n.d.). In the sedan contract between Auto Inc. and Trans-Atlantic Inc., MV Manhattan is strictly instructed by Auto Inc. in terms of the number of sedan cars to be dispatched, where to go, and when to dispatch. Not only that, but Auto Inc. can also control the use of assets (IFRS, n.d.). These clauses satisfy the requirement that the customer has the right to direct how and for what purpose the asset is used throughout its period of use, so under IFRS 16, as far as the sedan car contract is concerned, Auto Inc. does have the right to use the identified asset. It goes without saying that the right to control the use of an identifiable asset does not exist if there is no identifiable asset in the first place. So Auto Inc. does not have control over the identifiable assets in the luxury car contract (Li et al., 2024).

In general, FASB and IASB have gradually converged in determining whether a contract is a lease or contains a lease when formulating lease standards. However, there are still

differences in terms of effective date, Transition Approach, low-value threshold and lease classification (McCallum et al., 2020).

3. Conclusion

This case highlights the critical importance of correctly identifying and classifying leases under ASC 842 and IFRS 16. Businesses must thoroughly evaluate their contracts to determine whether they contain identifiable assets and whether the lessee has control over those assets. This ensures accurate financial reporting and compliance with relevant accounting standards. The analysis demonstrates that identifying specific assets in a contract and assessing the lessee's control over their use are essential steps in lease classification. In the case of the sedan contract, Auto Inc.'s control over MV Manhattan led to a clear determination that the contract constituted a lease, while the absence of an identifiable asset and control in the luxury car contract resulted in a different conclusion. Understanding the Impact of IFRS 16 and ASC 842 Differences:

Although the two standards have converged significantly, the retention of two lease types in ASC 842 compared to IFRS 16's single lease model means that companies operating in multiple jurisdictions may need to adopt different approaches to lease classification and reporting. This reinforces the need for companies to remain vigilant and adaptable when applying these standards to their global operations.

From the case, we can know that among the sedan car contract and the luxury car contract, only the sedan car contract has an identifiable asset, and that asset is MV Manhattan. MV Manhattan was committed to delivering Auto Inc. sedans for the duration of the contract and was also explicitly specified. Likewise, we also believe that the contract transfers right to control the use of MV Manhattan to Auto Inc. In the luxury car contract, there are no explicitly specified assets like MV Manhattan, so there are no identifiable assets, which means that there is no right to control the use of identifiable assets.

In conclusion, the analysis of Auto Inc. and Trans-Atlantic Inc.'s sedan and luxury car contracts under both ASC 842 and IFRS 16 provides a practical demonstration of how to identify and classify leases. Understanding the nuances of both standards allows businesses to navigate lease accounting with greater clarity and ensure compliance with regulatory requirements.

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