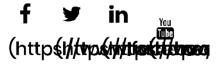

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Accounting for Leases Under the New Standard, Part 1

Definition and Classification of Leases and Lessee Accounting

By Robert Singer, PhD, CPA (https://www.cpajournal.com/author/rsinger/), Alyssa Pfaff (https://www.cpajournal.com/author/apfaff/), Heather Winiarski (https://www.cpajournal.com/author/hwiniarski/) and Mark Winiarski, CPA (https://www.cpajournal.com/author/mwiniarski/)

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In Brief

The new lease accounting standard, released by FASB in early 2016, represents one of the largest and most impactful reporting changes to accounting principles in decades. The standard itself is voluminous, and digesting it will be a major task for companies, auditors, and accountants. In part 1 of a two-part series, the authors discuss the changes to the definition and classification of different types of leases and detail the accounting process for lessees.

* * *

In Feb. 25, 2016, FASB published a new lease standard that represents a complete overhaul of financial reporting in this area. The new standard becomes effective for public business entities, certain not-for-profits, and certain employee benefit plans for annual periods (including interim periods) beginning after Dec. 15, 2018, and for all other entities, annual periods beginning after Dec. 15, 2019. The standard provides a long transition period; however, it requires entities to follow a modified retrospective approach, under which the required changes would apply to leases existing at the beginning of the earliest comparative period presented in the financial statements of the year the new standard is adopted. For example, a calendar-year public company presenting three comparative years would retrospectively apply the guidance to its income statement ending Dec. 31, 2017. The modified retrospective approach would not require any transition accounting for leases that have expired prior to the earliest period presented.

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When adopted, the new leasing guidance may have the largest-ever impact of a new accounting standard in terms of gross dollars on the balance sheets of lessees. A study commissioned by the Chamber of Commerce and other interested stakeholders in 2013 estimated the changes of the new standard would increase the total assets and total liabilities of publicly traded companies by some $1.5 trillion each, of which $1.1 trillion would come from capitalizing existing off–balance sheet real estate leases (Jeff Beatty, Ian Bilenness, Mile Nelson, Amie Sweeney, and Nick Tansey, "Revised Exposure Draft in Lease Accounting Issue: Back on Front Burner," *CBRE Global ViewPoint,* June 2013, **http://bit.ly/2urr2aJ (https://bit.ly/2urr2aJ)**).

The new rules require ongoing evaluation of leases to determine when an event occurs that may change the recognition or measurement of the lease, such as a change in the lease term or a modification to an existing agreement. In some instances, these changes will oblige an entity to distinguish between changes that are in essence modifications of an existing lease and those that constitute a new lease arrangement requiring separate accounting. Among the more challenging aspects of the new standard are requirements that the parties separate lease components within a contract, and identify and segregate non-lease components. The standard is replete with examples of how the parties might make such determinations.

Although accounting for leasing arrangements under the new standard for the lessor will not be substantively different from existing standards, a lessor's recognition of selling profit and revenue from lease transactions must conform to a part of Topic 606 regarding revenue recognition; if control is not transferred, the lessor will not be allowed to recognize selling profit upfront. The standard provides a number of practical expedients that will allow parties to avoid some of the more challenging areas of implementation. For example, one provision allows an entity (of particular importance to the lessee) to make an accounting election to retain off–balance sheet treatment for short-term leases (i.e., 12 months or less). A lessee making this election is required to apply the expedient to an entire class of leases based on the type of underlying asset.

While it is difficult to cover all aspects of such a large document (over 400 pages), this two-part article will focus on how the standard defines and specifies a contract as a lease or containing a lease, and how the respective parties classify their lease transactions, providing examples of how the standard will affect their accounting. It will also detail how the standard defines and distinguishes a modification from a new lease component and exceptions to some of the more difficult-to-implement provisions (i.e., practical expedients). Finally, consideration will be drawn to how the new standard might affect entities engaged in leasing, and how they might prepare for the transition.

What Is a Lease or Lease Component?

This first step for any analysis by a lessee or lessor is to determine if a lease exists within the scope of the new guidance. If so, the lessee and the lessor must also analyze whether there are multiple lease components (i.e., more than one lease) that should be accounted for separately, and whether there are non-lease components that should be accounted for under other appropriate GAAP. Based on ASC 842-10-15-3 and 842-10-15-4, the lessee must have direct control over the asset or be in a position to direct the manner and nature in which it is used. The standard provides numerous examples of when and how control over the underlying asset is achieved. For example, control depends on whether the lessor has "substantive substitution rights" and whether it derives a significant portion of the benefits from its ability to substitute alternative assets. Moreover, the lessee must derive most of the benefits from the use of the asset over the lease term.

Once a lease is identified, consideration is given to whether non-lease components exist. For example, when leasing a building, a lessee may obtain access to a communal parking lot and exercise facility. Assuming these components do not meet the definition of a lease, the lessor and lessee allocate the lease payments between the lease of the building and the non-lease services. This allocation may have a significant impact on the recognition of the right-of-use asset and liability for

the lessee and revenue for the lessor. The lessor in particular has the extra complexity of applying the new revenue recognition guidance in Topic 606 to the non-lease components. The lessee is given a practical expedient, discussed below, to ignore the effect of non-lease components.

Although not within the scope of this article, both the lessee and the lessor must give consideration to computing the allocation between lease and non-lease components, or between multiple lease components within a single arrangement. In addition, after identifying the lease and non-lease components, they must evaluate the term of the lease and the amount of lease payments in order to properly recognize and measure the lease. Another complication is identifying initial direct costs; that is, those costs that would not have been incurred were it not for the parties entering into a lease arrangement. An example of initial direct costs would be brokers' fees incurred in consummating the lease agreement.

Lessee Model

Although the new standard retains the existing model of having two types of leases, "operating" and "finance," the lessee's burden for recognition and measurement is increased. Under the old guidance, operating leases were not recorded on the balance sheet; therefore, many entities did not evaluate leases embedded in service agreements or other short-term leases that were known to be operating leases. For example, an entity might prepay for postage in an 18-month arrangement and receive use of a postage meter at each of its locations for "free." The entity might have previously excluded the usage of the free postage meter from its lease analysis because there was limited or no risk that the postage meter would be accounted for as a capital lease. Under the new guidance, an operating lease must be measured as a liability on the balance sheet, and thus the cumulative effect of the free postage meters, if meeting the definition of a lease, might be material to the financial statements and require identification, recognition, and measurement of a new liability.

The lessee first identifies its leases as discussed above, then determines whether the leases, based on five lease classification criteria, should be classified as operating or finance. These criteria are similar to the four criteria under the old guidance, but require greater judgment because they do not include explicit bright lines. A lease meeting any of the following five criteria is classified as a finance lease:

- Ownership is transferred at the end of the lease term.
- A bargain purchase option (i.e., one that is reasonably certain to be exercised) for the leased asset exists.
- The lease term, which does not commence near the end of the economic life of the leased asset, is primarily for the remaining economic life of the leased asset.
- The present value of the lease payments and residual value guarantees is equal to, or more than, substantially all of the fair value of the leased asset.
- The leased asset has no alternative use to the lessor at the end of the term because of its specialized nature.

Lessees will need to take positions on what constitutes the "major part" of the remaining economic life of the leased asset and "substantially all" of the fair value of the leased asset.

Critically, lessees will need to take positions on what constitutes the "major part" of the remaining economic life of the leased asset and "substantially all" of the fair value of the leased asset, which may or may not be consistent with the 75% and 90% thresholds, respectively, specified under previous GAAP.

After classifying each lease, the lessee must then measure them. The measurement of an operating lease is the most significant difference from previous GAAP; the lessee will be required to place all operating leases with a duration of 12 months or more on the balance sheet. These operating leases, which are presented separately from the finance leases, must have right-of-use assets and related lease obligation measured. At the effective commencement date, the lessee will measure both assets and liabilities at the present value of the prospective lease payments using either the lessor's implicit interest rate (which equates the present value of the payments received to the fair value of the lease asset), or if not readily determinable, at lessee's incremental borrowing rate (the rate at which lessee could borrow for a similar amount from their lending institution).

The increased burden on the lessee does not stop there, as accounting for and maintaining the assets and liabilities created by each lease is required each period. The ongoing accounting for finance leases will be substantially the same as the existing accounting for capital leases; however, the accounting for operating leases will be different due to the assets and liabilities now recognized. The sum of the lease payments of an operating lease will be amortized on a straight-line basis, with each payment charged to lease expense and corresponding credits 1) to the lease liability for accreted interest and 2) to the right-of-use asset for the difference. Assuming no modifications in the existing contract, the effect of this treatment would be to amortize the right-of-use asset using the effective interest method, which applies a constant interest rate to an unamortized obligation. While not explicitly stated, the effect of multiplying the interest rate used in the present value calculation by the amount of the lease liability and subtracting it from the total lease expense is to apply a constant rate to the right-of-use asset; at the end of the lease term, the right-of-use asset would then be completely written off.

Examples of Accounting for Operating Leases by a Lessee

In this example, a lessee accounts for a simple operating lease for a building with 10 equal annual lease payments. Assume the following:

- The lessee, A, signs an agreement with the lessor, B, to lease a building on Jan. 1, Year 1
- The lease period (no renewal options) is 10 years
- The annual lease payment, due on Dec. 31, is $162,745
- The lessee's incremental borrowing rate is 10%
- The present value of lease payments is $1 million
- Initial direct costs are $0
- The remaining economic life of the asset is 20 years
- The estimated fair value of the building is $2 million

- The underlying asset is transferred back to lessor at end of the lease term.

It is reasonable to conclude that the lessee would account for the lease arrangement as an operating lease. The lease term is only one half of the estimated economic life of the underlying asset, the present value of the lease payments is only 50% of the fair value of the underlying asset, and the asset is transferred back to lessor at the end of the lease term. Therefore, the lessee would make the journal entries for year 1 and year 2 shown in ***Exhibit 1*** **(https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=9501#T1)**.

EXHIBIT 1

Illustrative Journal Entries for Simple Operating Lease – Lessee

		Dr.	Cr.
1/1/Year 1	Right-of-Use Asset	1,000,000	
	Lease Liability		1,000,000

Lease Liability at 1/1/Year 1: Present value of ordinary annuity for $162,745 per year at 10% for 10 years = $1,000,000

		Dr.	Cr.
12/31/Year 1	Lease Expense	162,745	
	Lease Liability		100,000
	Right-of-Use Asset		62,745

Lease Expense: $162,745 × 10 years/10 years (straight-line method) = $162,745

Accreted Interest On Lease Liability: $1,000,000 × 10% = $100,000

Right-of-Use Asset at 12/31/Year 1: $1,000,000 − $62,745 = $937,255

		Dr.	Cr.
	Lease Liability	162,745	
	Cash		162,745

Lease Liability at 12/31/Year 1: $1,000,000 + $100,000 − $162,745 = $937,255

		Dr.	Cr.
12/31/Year 2	Lease Expense	162,745	
	Lease Liability		93,726
	Right-of-Use Asset		69,019

Lease Expense: $162,745 × 10 years/10 years (straight-line method) = $162,745

Accreted Interest on Lease Liability: $937,255 × 10% = $93,726

Right-of-Use Asset at 12/31/Year 2: $937,255 − $69,019 = $868,236

		Dr.	Cr.
	Lease Liability	162,745	
	Cash		162,745

Lease Liability at 12/31/Year 2: $937,255 + $93,726 − $162,745 = $868,236

The effect of the above entries is to amortize both the right-of-use asset and the related lease liability using the effective interest method. At the end of the two-year period, the right-of-use asset has been amortized to $868,236, and the lease liability has been amortized to the same amount.

In the above example, the operating lease did not include any of the more common characteristics that can arise in property leases, and thus the lease expense and operating cash flows were recognized in each year during the 10-year term and the right-of-use asset and lease liability, although not offset in the balance sheet, were equal. Such a simple lease can be complicated by factors such as initial direct costs, lease incentives, and increasing rate lease payments. If there had been initial direct costs, the lessee would have included them as part of the lease cost, and thus they would have been amortized on a straight-line basis. Likewise, lease incentives and variable lease payments are also amortized on a straight-line basis. The impact of initial direct costs or variable lease payments would be that the

lease expense would no longer be the same as the operating cash flows related to the lease, and the right-of-use asset and lease liability would no longer be equal at the end of each period. To illustrate, assume the same facts as above, except that the annual lease payment due at Dec. 31 is $150,000 for years 1–5, and $183,272 for years 6–10.

Exhibit 2 **(https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=9501#T2)** shows the changes in the lease accounting. At the end of the two-year period, the right-of-use asset has been amortized to $869,510, and the lease liability has been amortized to $895,000, a difference of $25,490. Net income was reduced in year 1 and year 2 by the lease expense of $162,745, but cash outflows were only equal to $150,000, resulting in a net add-back in the operating section of the cash flow statement of $12,745 in each year.

EXHIBIT 2

Illustrative Journal Entries for Operating Lease with Variable Lease Payments – Lessee

		Dr.	Cr.
1/1/Year 1	Right-of-Use Asset	1,000,000	
	Lease Liability		1,000,000

Lease Liability at 1/1/Year 1: Present value of $150,000 for five years and then $183,272 for the next five years at 10% = $1,000,000

12/31/Year 1	Lease Expense	162,745	
	Lease Liability		100,000
	Right-of-Use Asset		62,745

Lease Expense: $162,745 × 10 years/10 years (straight-line method) = $162,745
Accreted Interest On Lease Liability: $1,000,000 × 10% = $100,000
Right-of-Use Asset at 12/31/Year 1: $1,000,000 – $62,745 = $937,255

	Lease Liability	150,000	
	Cash		150,000

Lease Liability at 12/31/Year 1: $1,000,000 + $100,000 – $150,000 = $950,000

12/31/Year 2	Lease Expense	162,745	
	Lease Liability		95,000
	Right-of-Use Asset		67,745

Lease Expense: $162,745 × 10 years/10 years (straight-line method) = $162,745
Reduction of Lease Liability: $950,000 × 10% = $95,000
Right-of-Use Asset at 12/31/Year 2: $937,255 – $67,745 = $869,510

	Lease Liability	150,000	
	Cash		150,000

Lease Liability at 12/31/Year 2: $950,000 + $95,000 – $150,000 = $895,000

Examples of Accounting for Finance Leases by a Lessee

In this example, the lessee leases a piece of machinery, and the lease is classified as a finance lease. Assume the following:

- Company A leases machinery from Company B on Jan. 1, Year 1
- The lease period is for 15 years
- The cost of the machinery is $1 million, purchased by the lessor on Jan. 1, Year 1
- The estimated economic life of the machinery is 15 years

- The depreciation method is straight-line
- There is no residual value
- The rate implicit in the lease, of which the lessee has knowledge, is 10%
- The lease payments, due at Dec. 31, are $131,473.

This lease is a finance lease for two reasons: 1) the lease term represents 100% of the useful economic life of the underlying asset, and 2) the present value of the lease payments equals the fair value of the underlying asset. ***Exhibit 3*** **(https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=9501#T3)** shows the lease accounting.

EXHIBIT 3

Illustrative Journal Entries for Simple Finance Lease – Lessee

		Dr.	Cr.
1/1/Year 1	Right-of-Use Asset	1,000,000	
	Lease Liability		1,000,000

Lease Liability at 1/1/Year 1: Present value of ordinary annuity for $131,473 per year at 10% for 15 years = $1,000,000

		Dr.	Cr.
12/31/Year 1	Amortization Expense	66,667	
	Right-of-Use Asset		66,667

Amortization Expense: $1,000,000/15 years = $66,667
Right-of-Use Asset at 12/31/Year 1: $1,000,000 – $66,667 = $933,333

		Dr.	Cr.
	Interest Expense	100,000	
	Lease Liability	31,473	
	Cash		131,473

Interest Expense: $1,000,000 × 10% = $100,000
Lease Liability at 12/31/Year 1: $1,000,000 – $31,473 = $968,527

		Dr.	Cr.
12/31/Year 2	Amortization Expense	66,667	
	Right-of-Use Asset		66,667

Amortization Expense: $1,000,000/15 years = $66,667
Right-of-Use Asset at 12/31/Year 2: $933,333 – $66,667 = $866,667

		Dr.	Cr.
	Interest Expense	96,853	
	Lease Liability	34,620	
	Cash		131,473

Interest Expense: $968,527 × 10% = $96,853
Lease Liability at 12/31/Year 2: $968,527 – $34,620 = $933,907

Note that FASB decided to retain the decoupled nature of the right-of-use asset from the related lease liability of a capital lease under the previous guidance in the accounting under the new guidance. As a result, although lessees recognize both operating and finance leases on the balance sheet, the income statement impact of each differs. Absent a more systematic approach, the lessee would be required to amortize the right-of-use asset on a straight-line basis over the lease term, or the estimated useful life of the underlying asset if ownership were transferred to the lessee. In this example, the lessee amortized the right-of-use asset on a straight-line basis while using the required effective interest method to amortize the lease liability. This accounting treatment results in a greater expense in earlier years, followed by a lesser expense in later years. With respect to operating leases, the lessee would classify the annual rental payment as an operating expense on the

income statement. In contrast, classification as a finance lease would result in the lessee having to record a portion of the annual lease as an operating expense (amortization associated with the right-ofuse asset) and the other portion of the amortization as a nonoperating expense (amortization associated with the lease liability as interest expense).

A final example for lessees explores some of the additional complexity associated with initial directs costs and the existence of residual values. The entries in ***Exhibit 4*** **(https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=9501#T4)** illustrate how the lessee accounts for a finance lease given initial direct costs and residual value (guaranteed and unguaranteed). The only changes in the assumptions from ***Exhibit 3*** **(https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=9501#T3)** are the following:

- The lease payments are $105,179 per year, due Dec. 31
- The carrying value of the equipment is $700,000
- The total profit at the commencement date is $300,000
- The residual value at end of 15 years is $835,450
- The lessee guarantees a residual value of $600,000; the remaining $235,450 is unguaranteed
- Collectibility, including the residual guarantee, is probable
- Initial direct costs, not included in lease payments, are $10,000
- The parties agree that the lessee should bear the initial direct costs.

EXHIBIT 4

Illustrative Journal Entries for Finance Leases With Initial Direct Costs and Guaranteed and Unguaranteed Residual Value – Lessee

		Dr.	Cr.
1/1/Year 1	Right-of-Use Asset	953,635	
	Lease Liability		943,635
	Cash		10,000

Lease Liability at 1/1/Year 1: Present value of $105,179 for 14 years and then $705,179 in the 15th year ($105,179 lease payment + $600,000 residual value guarantee) at 10% = $943,635

12/31/Year 1	Amortization Expense	63,576	
	Right-of-Use Asset		63,576

Amortization Expense: $953,635/15 years = $63,576
Right-of-Use Asset at 12/31/Year 1: $953,635 – $63,576 = $890,059

	Interest Expense	94,364	
	Lease Liability	10,815	
	Cash		105,179

Interest Expense: $943,635 × 10% = $94,364
Lease Liability at 12/31/Year 1: $943,635 – $10,815 = $932,820

12/31/Year 2	Amortization Expense	63,576	
	Right-of-Use Asset		63,576

Amortization Expense: $953,635/15 years = $63,576
Right-of-Use Asset at 12/31/Year 2: $890,059 – $63,576 = $826,483

	Interest Expense	93,282	
	Lease Liability	11,897	
	Cash		105,179

Interest Expense: $932,820 × 10% = $93,282
Lease Liability at 12/31/Year 2: $932,820 – $11,897 = $920,923

The right-of-use asset would consist of the present value of the lease payments plus the present value of the residual guarantee plus initial direct costs.

The second part of this article will cover lessor accounting under the new standard, as well as rules covering changes in lease terms, the practical expedients allowed under the new guidance, and suggestions on how companies should prepare for the transition to the new standard.

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