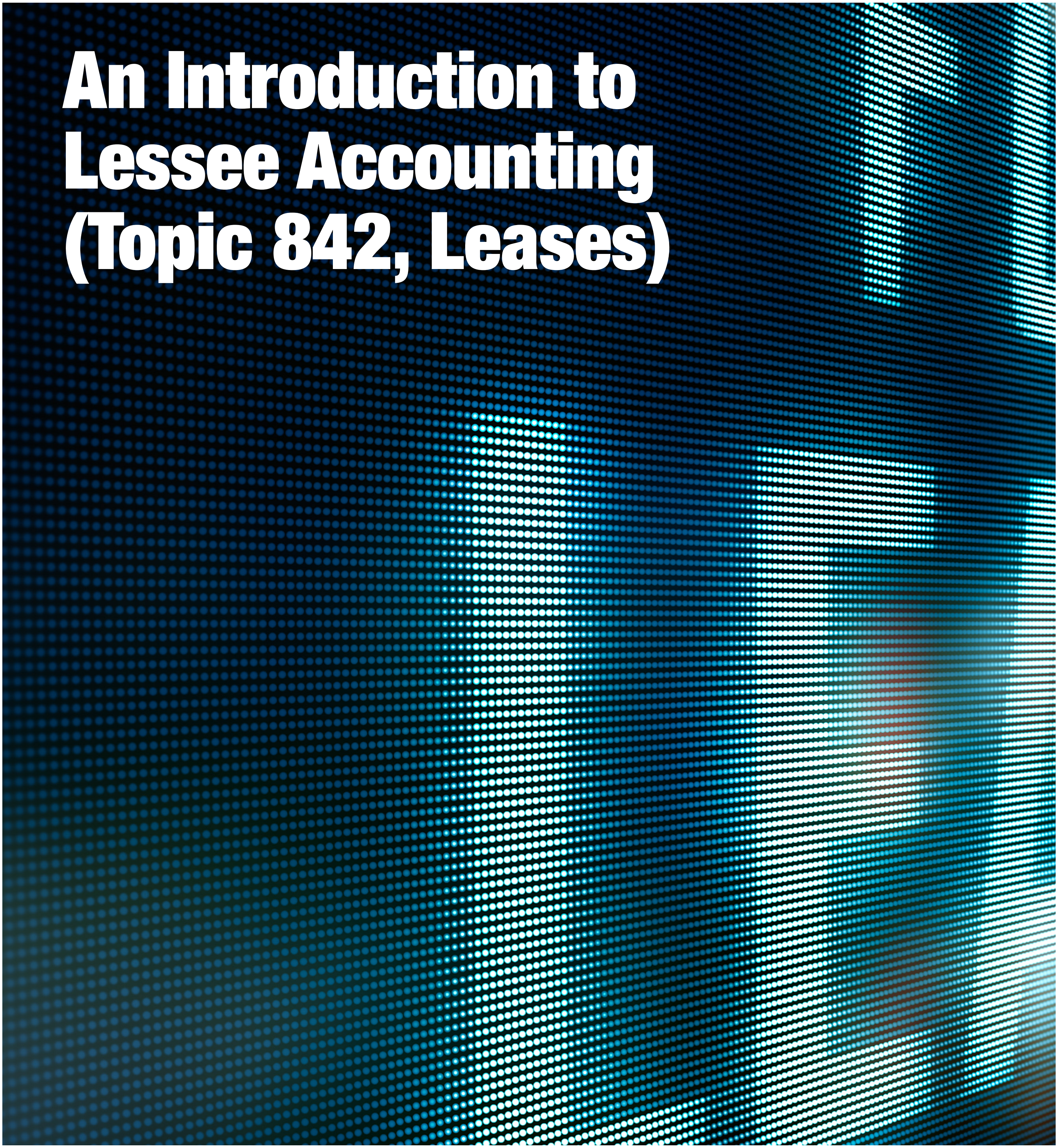
An Introduction to Lessee Accounting (Topic 842, Leases)



Curriculum: Accounting and auditing

Level: Basic

Designed For: Public practitioners and business and industry

Objectives: To provide an introduction to lessee accounting under the new FASB guidance (ASC 842)

Key Topics: Lessee accounting and presentation of financial statements

Prerequisites: None

Advanced Preparation: None

By Josef Rashty and John O'Shaughnessy

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*. The International Accounting Standards Board (IASB) issued its own version of lease accounting earlier (IFRS 16). Although the project was a convergence project, and FASB and IASB (the Boards) conducted joint deliberations, the two standards contain several notable differences. Topic 842 will supersede the existing lease guidance (Topic 840), which has been in effect since 1977.

Under the new standards, both FASB and IASB guidance now require lessees to reflect virtually all leases on their balance sheets and to recognize the expenses from lease contracts in earnings. Since the primary objective of the convergence project was to address "off-balance-sheet" treatment of operating lease obligations by lessees, it appears that the project has been successful in that regard. However, as it will be discussed in this article, the Boards have chosen divergent expense recognition models for lessees.

The task of eliminating off-balance-sheet leases was not trivial and the Boards went through several iterations to achieve that objective. In its November/December 2011 issue, *Today's CPA* published an article on lessee accounting based on the exposure draft, "The Ever-

continued on next page

Changing Lease Exposure Draft" (Rashty and O'Shaughnessy). There are notable differences between the guidance in the exposure draft and the standard that was finally approved. This article is thus an update of the earlier publication.

Definition of a Lease Contract

A lease contract principally gives a customer the right to control the use of the underlying asset for a period of time in exchange for consideration (ASC 842-10-15-3). In a lease contract, a lessee has both of the following characteristics (ASC 842-10-15-4):

- The right to obtain substantially all of the economic benefits from use of the underlying asset.
- The right to direct the use of the underlying asset.

An entity is required at the outset to determine if a contract is or contains a lease agreement, and to reassess its status only in the event of modifications to the contract.

The following lease agreements are not within the scope of the new lease guidance (ASC 842-10-15-1):

- Leases of intangible assets.
- Leases to explore for, or use of, minerals.
- Leases of biological assets.
- Leases of inventory.
- Leases of assets under construction.

Therefore, ASC 842 has diverged from ASC 840 by stating that leases convey the right to control the property rather than the right to use the property. Thus, if control does not exist, a lease does not exist either under the new guidance regardless of the extent of the use of the property. The concept of control in ASC 842 is very similar to the concept of control in the new revenue recognition guidance (ASC 606).

The Major Difference Between FASB and IASB Guidance

FASB and IASB both agreed on the key issue that lessees must reflect lease obligations in their balance sheets. However, IASB decided on a single model of recognition for lessees, while FASB adopted a dual model. Under FASB's model, lessees account for the majority of existing capital leases as finance leases, whereas most operating leases will be accounted for as new operating leases. This is in contrast with IASB's adopted model and the earlier version of lease exposure draft that requires lessees to account for all their leases as finance leases.

Key Provisions of FASB's Model

Lessees are required to recognize a right-of-use (ROU) asset and a lease liability on their balance sheets for virtually all lease obligations (with the exception of short-term leases). Under the new guidance, a lessee can elect (by asset class) not to reflect on its balance sheet a lease whose term is 12 months or less and that does not contain a purchase option that the lessee is reasonably certain to exercise.

FASB has adopted a dual model in lessee accounting that requires leases to be classified as operating or finance leases. Finance leases under Topic 842 (the new standard) are categorically no different than capital leases under Topic 840 (the existing standard). However, there are some differences in their treatments; for example, as will be discussed later in this article, the classification guidance for finance leases are to some extent different than capital leases, but the basic accounting premise remains the same for capital leases under the existing standard and finance leases under the new standard. Operating leases reflect lease expenses on a straight-line basis (similar to operating leases in existing guidance), whereas finance leases will result in front-loaded lease expenses (similar to current capital leases in existing guidance).

The standard is effective for public companies for fiscal years (and interim periods within those fiscal years) beginning after Dec. 15, 2018. For private companies, the standard is effective for fiscal years beginning after Dec. 15, 2019 (and interim periods beginning the following year). The standard permits early adoption and requires use of a modified retrospective transition method.

The new standard also requires extensive quantitative and qualitative disclosures, and discussion of the judgments that management has exercised for adoption of a particular accounting policy. The classification of leases into operating and finance leases under the new guidance is based on certain criteria that are similar to existing lease guidance, but the new standard lacks any bright lines.

Lease Classification

The current standard (ASC 840-10-25-1) requires that lessees consider whether a lease meets any of the following criteria as part of classifying the lease at its inception into a capital or operating lease:

1. The lease transfers ownership of the lease item to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased item.
4. The present value of the minimum lease payments (with certain exceptions) at the beginning of the lease term equals or exceeds 90 percent of the excess of the fair value of the leased item to the lessor at lease inception (with certain exceptions).

However, the new guidance (Topic 842) has eliminated the bright line criteria in (3) and (4) above and has replaced the above criteria with the following five subjective guidelines (ASC 842-10-25-2):

1. The lease agreement transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset and the lessee is reasonably certain that it will exercise the option.
3. The lease term covers the major remaining economic life of the underlying asset.
4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.
5. The underlying asset has such a specialized nature that is expected to have no alternative use to the lessor at the end of the lease.

The objective of ASC 842 is to ensure that the control of the underlying asset is transferred to the lessee, and the lessee has the

Exhibit 1. The Different Lease Accounting Models Under Existing and New Guidance

	ROU	Liabilities	Lease Expenses	Amortization Expense	Finance Charges	Total
Operating leases (ASC 840)						
Inception	- (1)	- (2)	-	-	-	-
First year	-	-	$12,000 (3)	-	-	$12,000
Second year	-	-	$12,000 (3)	-	-	$12,000
Third year	-	-	$12,000 (3)	-	-	$12,000
Capital leases (ASC 840)						
Inception	$33,036 (4)	$33,036 (4)	-	-	-	-
First year	$22,024 (6)	$22,563 (5)	-	$11,012 (6)	$1,527 (7)	$12,539
Second year	$11,012 (6)	$11,619 (5)	-	$11,012 (6)	$1,056 (7)	$12,068
Third year	-	- (11)		$11,012 (6)	$381 (7)	$11,393
Finance leases (ASC 842)						
Inception	$33,036 (4)	$33,036 (4)	-			
First year	$22,024 (6)	$22,563 (5)	-	$11,012 (6)	$1,527 (7)	$12,539
Second year	$11,012 (6)	$11,619 (5)	-	$11,012 (6)	$1,056 (7)	$12,068
Third year	-	- (11)		$11,012 (6)	$381 (7)	$11,393
Operating leases (ASC 842)						
Inception	$33,036 (4)	$33,036 (4)	-	-	-	-
First year	$22,563 (9)	$22,563 (9)	$12,000 (3)	-	-	$12,000
Second year	$11,619 (10)	$11,619 (10)	$12,000 (3)	-	-	$12,000
Third year	- (11)	- (11)	$12,000 (3)	-	-	$12,000

(1) Assets are not reflected on the balance sheet.
(2) Liabilities are disclosed as off-balance-sheet items.
(3) Monthly lease payments under the lease agreement.
(4) Discount value of the total monthly lease payments.
(5) Inception year discount value of $33,036 less subsequent effective interest amortization.
(6) Annual straight-line three-year amortization.
(7) Effective interest rate calculation.
(8) First year discount book value of $22,024 less $11,012 annual straight-line amortization.
(9) Inception discount value of $33,036 less principal amortization of $10,472 (present value calculation not shown).
(10) First year discount book value of $22,563 less principal amortization of $10,944 (present value calculation not shown).
(11) Second year discount book value of $11,619 less principal amortization of $11,619 (present value calculation not shown).

risks and rewards of ownership. Even though FASB has eliminated the bright lines in ASC 840, it does not necessarily prohibit an entity from applying them within the framework of the new guidance.

Lessee Accounting

The lessee at the commencement of a lease reflects the following under the new guidance (Topic 842):

- A liability for its lease obligation measured based on the present value of the future lease payments not yet paid. The lessee uses the effective interest method to subsequently account for lease liability.
- An asset representing the right to use the underlying asset (i.e., right-of-use asset or ROU) and is initially equal to the lease liability. ASC 842 provides for two approaches for amortization of ROU: the finance lease approach and the operating lease approach. The determination of which approach to use is based on the criteria discussed earlier.

ASC 842 financing leases have the potential for being more front-end loaded compared to the ASC 840 capital leases, due to the criteria used for determination of lease terms. ASC 840 capital leases use the initial lease term for capitalization and each new lease option initiates a new lease. ASC 842 finance leases use the most probable lease option for the term used in the initial capitalization of the lease. Therefore, ASC 842 finance leases potentially can

continued on next page

Exhibit 2. Impact of Different Lease Transactions on the Statement of Cash Flows

Type of Leases	Transactions	Impact on Statement of Cash Flows
All leases	ROU and lease liability recognition at the inception of the lease	• Are not reflected on the statement of cash flows, but are disclosed as footnotes to the statement of cash flows.
Operating leases (ASC 840)	Lease expenditures	• Are reflected in the operating activities section of the statement of cash flows.
Capital leases (ASC 840)	Amortization expenses Interest charges Principal payments	• Are added back to net income as non-cash expenditures as part of the operating activities section of the statement of cash flows. • Are reflected in the operating activities section of the statement of cash flows. • Are reflected in the financing activities section of the statement of cash flows.
Finance leases (ASC 842)	Amortization expenses Interest charges Principal payments	• Are added back to net income as non-cash expenditures as part of the operating activities section of the statement of cash flows. • Are reflected in the operating activities section of the statement of cash flows. • Are reflected in the financing activities section of the statement of cash flows.
Operating leases (ASC 842)	Reduction in ROU and lease liability	• Are not reflected on the statement of cash flows, but are disclosed as footnotes to the statement of cash flows.

capitalize a longer stream of lease payments over a longer period of lease terms. As a result, ASC 842 leases may become more front-loaded than ASC 840 capital leases.

Finance leases use the effective interest method for attrition of lease liabilities and straight-line method for amortization of ROUs. Operating leases, on the other hand, use the effective interest method for attrition of lease liabilities, and determine the ROU amortization based on the difference between lease expense and interest expense on a given lease obligation. However, when lease expenses equal lease payments (i.e., lease payments do not change through the term of the lease), the amortization of ROUs equals the effective interest method attrition of the lease liabilities.

Illustration

Exhibit 1 compares and contrasts the four different lease accounting models under the existing and the new guidance.

In Exhibit 1, the lessee enters into a three-year lease agreement and agrees to make a monthly payment of $1,000 a month to the lessor. The initial measurement of the ROU and lease liability to make the lease payments at a discount rate of 6 percent per year is $33,036. The objective of this illustration is to reflect the financial impact of different classifications of the same contract (of course, in practice a lease agreement can only be classified as one category).

Exhibit 2 reflects the impact of different lease transactions in the four lease models of Exhibit 1 on the statement of cash flows (assuming an indirect method presentation).

An Overview and Introduction Only

There are significant judgments involved in selection of a specific lease model under Topic 842. Each model impacts the financial statements of lessees differently and significantly. In this article, the authors provided an overview and introduction to FASB's new guidance. There are many details and fine points that were intentionally left out of the article, as they did not deem to be within the scope of, and relevant to, an introductory article.

In most instances, operating leases under Topic 840 can be classified as operating leases under Topic 842 and capital leases under Topic 840 can be classified as finance leases under Topic 842. However, since the bright lines under Topic 840 have been replaced by subjective judgments under Topic 842, it is quite plausible that leases may receive cross-classification treatment during implementation.

Even though the effective date of the guidance is a few years away, and it may even be possibly further delayed, it is important that companies start planning for implementation of the new guidance as soon as possible, due to its complexity and potential significant impact on the financial statements of the reporting entities. ■

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1 The article claims that the primary objective of the lease convergence project was to:

- **A.** Address the "off-balance-sheet" treatment of lease obligations.
- **B.** Identify operating leases.
- **C.** Eliminate capital leases.
- **D.** None of the above.

2 The criterion for a lease contact under ASC 842 is to:

- **A.** Identify who carries the risks and rewards.
- **B.** Transfer the risk and reward from lessor to lessee.
- **C.** Give the customer the right to control the underlying asset.
- **D.** Benefit the lessor rather than the lessee.

3 Leases of inventory items are within the scope of ASC 842:

- **A.** On some instances.
- **B.** If lessor elects them to be.
- **C.** If lessee elects them to be.
- **D.** None of the above.

4 The FASB model (ASC 842) adopts _________ for recognition of operating leases or finance leases by lessees.

- **A.** A single model.
- **B.** A dual model.
- **C.** Both (a) or (b).
- **D.** Neither (a) or (b).

5 Lessees are required to recognize a right-of-use (ROU) on their statement of earnings, but a lease liability on their balance sheets.

- **A.** True.
- **B.** False.

6 Under Topic 842, finance leases:

- **A.** Are similar to the existing ASC 840 operating leases.
- **B.** Result in straight-line lease expenses.
- **C.** Are similar to the existing ASC 840 capital leases.
- **D.** None of the above.

7 Which of the following is false?

- **A.** IASB decided on a single model of recognition for lessees, while FASB adopted a dual model.
- **B.** IASB's adopted lease model requires lessees to account for all their leases as finance leases.
- **C.** An earlier version of lease exposure draft required lessees to account for all their leases as finance leases.
- **D.** None of the above is false.

8 Under existing criteria (Topic 840), one of the criteria for capitalizing a lease is, "The present value of the minimum lease payments (with certain exceptions) at the beginning of the lease term equals or exceeds 90 percent of the excess of the fair value of the leased item to the lessor at lease inception." A similar criterion exists in the new guidance (Topic 842), "The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset."

- **A.** True.
- **B.** False.

9 ASC 842 finance leases use the most probable lease option for the term used in the initial capitalization of the lease. This contrasts with the existing ASC 840 capital lease whereby the initial lease term is used for capitalization and each new lease option initiates a new lease. As such, ASC 842 finance leases potentially can capitalize a longer stream of lease payments over a longer period of lease terms and as a result, may become more front-loaded than ASC 840 capital leases.

- **A.** True
- **B.** False

10 Which of the following is false regarding Topic ASC 842?

- **A.** Operating leases use the straight-line method for attrition of the lease liability.
- **B.** Finance leases use the effective interest method for attrition of the lease liability.
- **C.** Finance leases use the straight-line method for amortization of the ROU.
- **D.** Operating leases determine the ROU amortization based on the difference between the lease expense and the interest expense on the lease obligation.

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