

Financial Reporting Brief: Leases



Accounting for leases began as a convergence project between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). However, the boards were unable to reach a consensus on some key issues, and some significant differences remain between International Financial Reporting Standard (IFRS) 16 and the FASB’s lease standard. This Financial Reporting Brief focuses on the FASB’s standard, but also points out some significant differences between the two standards.

On February 25, 2016, the FASB issued Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*. Under the new standard, lessees will be required to recognize lease assets and liabilities for all leases, with certain exceptions, on their balance sheets.

Public business entities¹ are required to adopt the standard for reporting periods beginning after December 15, 2018. That means an effective date of January 1, 2019 for public entities with a December 31 year end.

Nonpublic entities have an extra year to adopt. All entities may elect to early-adopt.

Scope

The new standard applies to all entities: public, private, and not-for-profit, whether large or small.

It applies to all leases, including subleases, other than the following:

- a. Leases of intangible assets
- b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources
- c. Leases of biological assets, including timber
- d. Leases of inventory
- e. Leases of assets under construction

¹ The term “public business entity” also includes a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and an employee benefit plan that files or furnishes statements with or to the SEC.

Lessee Accounting

Under the new standard, both financing leases and operating leases would create an asset (right-of-use, or ROU asset) and a liability, initially measured at the present value of the lease payments, to be reflected on the balance sheet. For leases whose term is 12 months or less, however, lessees may make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities.

Leases will be classified in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee). In contrast to existing lease requirements, however, there are no “bright-lines” in applying that principle. Nevertheless, a lessee would account for most existing capital leases as finance leases and most existing operating leases as operating leases.

The income statement treatment of Type A (financing) and Type B (operating) leases is different. For financing leases, lessees will recognize amortization of the ROU asset separately from interest on the lease liability. For operating leases, lessees will recognize a single total lease expense.

Under IFRS, lessees must account for all leases as finance leases (that is, recognizing amortization of the ROU asset separately from interest on the lease liability).

IFRS provides an explicit exception for “small ticket” leases (under \$5,000).

Lessor Accounting

Lessors will determine lease classification based on whether the lease is effectively a financing or a sale, rather than an operating lease. That determination is made by assessing whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Lessors will account for the leases using an approach that is substantially equivalent to existing U.S. GAAP for sales-type leases, direct financing leases and operating leases.

In addition, selling profit will be recognized at commencement only for sales-type leases, which aligns with the new revenue recognition standard (ASC Topic 606).

Lessors must also assess collectability. If the lease does not transfer control of the underlying asset and collectability is not probable, the lease should be classified and accounted for as an operating lease. If the lease does, in effect, transfer control of the underlying asset but collectability is not probable, it should be accounted for in accordance with the collectability guidance applicable to all sales of nonfinancial assets in ASC Topics 606 and 610.

Accounting for existing leveraged leases is grandfathered during transition. Otherwise, leveraged lease accounting is eliminated.

Lessors must also assess their entire net investment in the lease (that is, the combined lease receivable and any unguaranteed residual asset) for impairment in accordance with the guidance applicable to impairment of receivables. Accordingly, the unguaranteed residual asset should not be assessed for impairment in accordance with the guidance on property, plant, and equipment.

Definition of a Lease

The new standard defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (the underlying asset) for a period of time in exchange for consideration.

Under current GAAP, in order for the purchaser (lessee) to have control, it need only have the ability or right to operate the property, plant or equipment or direct others to operate the property, plant or equipment while obtaining or

controlling more than a minor amount of the output or other utility of the property plant, or equipment. Under the new ASU, taking even all of the output of an underlying asset would not be sufficient, by itself, to constitute control.

Also, current GAAP does not require that there be an “identified” asset. Under the new ASU, a contract would not involve the use of an identified asset—and thus would not be a lease—if the supplier has the substantive right to substitute the asset used to fulfill the contract.

Lease and Nonlease Components

Lessors must separate lease and nonlease components of a contract by allocating the transaction price to separate performance obligations in accordance with the Board’s new standard on revenue recognition. Lessees must allocate components of a contract on a relative standalone price basis. (For lessees, a residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.) Lessees, however, are permitted an accounting policy election by class of underlying asset: they may separate the lease and nonlease components or account for the lease and nonlease components together as a single component.

Measurement

Lease Term and Purchase Options

In determining the lease term, an entity should consider all relevant factors that create an economic incentive to exercise an option to extend, or not to terminate, a lease. Such an option should be included in the lease term only if it is reasonably certain that the lessee will exercise the option having considered all relevant economic factors, or if exercise of the option is controlled by the lessor. Reasonably certain is a high threshold substantially the same as reasonably assured in existing GAAP.

Lessees should reassess the lease term only in specified circumstances. Lessors are not required to reassess the lease term unless the lease is modified.

Purchases options are accounted for the same way as options to extend, or not terminate, a lease.

Variable and In-Substance Fixed Lease Payments

Only variable lease payments that depend on an index or a rate should be included in the initial measurement of lease assets and lease liabilities. An entity should measure those payments using the index or rate at commencement. A lessee should reassess variable lease payments that depend on an index or a rate only when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term). Lessors are not required to reassess variable lease payments that depend on an index or rate.

IFRS also requires a lessee to reassess variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate, that is, when an adjustment to the lease payments takes effect.

In-substance fixed payments are included in the definition of lease payments.

Discount rate

A lessee should discount lease payments at the rate the lessor charges the lessee (that is, the rate implicit in the lease) when that rate can be readily determined. Otherwise, the lessee should use its own incremental borrowing rate. Entities that are not public business entities have an accounting policy election to use the risk-free rate.

IFRS contains no accounting policy election for private companies to use the risk-free rate.

A lessor should use the rate implicit in the lease and should include initial direct costs in determining that rate.

Lessees should reassess the discount rate only when there is a change to either the lease term or the assessment of whether the lessee is (or is not) reasonably certain to exercise an option to purchase the underlying asset. Lessors are not required to reassess the discount rate.

Lease Modifications

Both a lessee and a lessor should account for a lease modification as a separate lease (that is, separate from the original contract) when (a) the modification grants the lessee an additional right of use not included in the original lease and (b) the additional right of use is priced commensurate with its standalone price. Lease modifications that only extend the lease term never qualify as a new lease because they do not grant the lessee an additional right of use but only change the right of use the lessee already controls.

Subleases

An intermediate lessor (that is, an entity that is both a lessee and a lessor of the same underlying asset) should account for the head lease and the sublease as two separate contracts unless specified contract combination criteria are met. The intermediate lessor should account for the head lease in accordance with lessee accounting, and should account for the sublease in accordance with lessor accounting.

When classifying a sublease, the intermediate lessor should base the classification on the underlying asset and not the ROU asset arising from the head lease.

Under IFRS, the intermediate lessor should base the classification on the ROU asset arising from the head lease.

An intermediate lessor should not offset lease income and lease expense unless it recognizes sublease income as revenue and acts as an agent in accordance with revenue recognition guidance.

Sale-Leaseback Transactions

In order for a sale to occur in a sale-leaseback transaction, the sale must meet the requirements for a sale in the Board's new revenue recognition guidance (ASU Topic 606). The presence of a leaseback does not, in isolation, preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor. Under the new standard, a sale will not have occurred if the leaseback is a finance lease for the seller-lessee. A substantive repurchase option does not preclude sale treatment if (a) the option is exercisable only at the then-prevailing fair value and (b) the underlying asset is readily available in the marketplace. A "failed" sale is treated as a financing transaction by both the seller-lessee and the buyer-lessor.

Under IFRS, a sale has not occurred if the seller has a substantive repurchase option.

If a sale-leaseback results in a sale, the buyer-lessor should account for the purchase of the underlying asset in accordance with the guidance that applies to any other purchase of a nonfinancial asset. Similarly, the seller-lessee should account for the sale of the underlying asset in accordance with the guidance that applies to similar sales, that is, the new revenue recognition guidance.

Under IFRS, the gain recognized on a completed sale in a sale-lease back is limited to the amount of the gain that relates to the residual interest in the underlying asset at the end of the leaseback.

The seller-lessee and the buyer-lessor should account for the leaseback as they would account for any other lease.

Any potential "off-market" adjustments should be determined based on the difference between (a) the sale price and the fair value of the underlying asset or (b) the present value of the contractual lease payments and the present value of market lease payments, whichever is more readily determinable. If the difference is a deficiency, it is accounted for in the

same manner as a prepayment of rent; if the difference is an excess, it is accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

Balance Sheet Presentation

Lessees should disclose as separate line items on the balance sheet assets that result from Type A leases, assets that result from Type B leases, liabilities that result from Type A leases, and liabilities that result from Type B leases. Alternatively, lessees may disclose those amounts in the notes to financial statements, also indicating which line items in the balance sheet contain those amounts.

Under IFRS, if the lessee does not present ROU assets as separate line items on the balance sheet, it should present ROU assets within the same line item as the underlying assets would be presented if they were owned, and disclose in the notes which line item in the balance sheet includes ROU assets.

Lessors should present their net investment in sales-type and direct financing leases separate from the lessors' other assets.

Statement of Cash Flows Presentation

Lessees should classify cash payments related to leases as follows:

- a. Cash payments for the principal portion of the lease liability within financing activities
- b. Cash payments for the interest portion of the lease liability arising from finance leases within operating activities
- c. Cash payments arising from operating leases within operating activities
- d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities

Under IFRS, lessees should classify the interest portion of the lease liability as either operating or financing activities in accordance with IFRS 16.

Lessors should classify cash receipts from leases within operating activities.

Disclosures

Lessees are required to disclose both qualitative and quantitative information about leases, including, among other things:

- The nature and terms of the leases
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee
- Significant assumptions and judgments made in applying the leases standard
- The main terms and conditions of any sale-leaseback transactions
- Whether an accounting policy election was made for the short-term lease exemption

IFRS does not specify the qualitative information a lessee should provide about its leases. Instead, IFRS requires lessees to disclose sufficient additional information to satisfy the overall disclosure objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. That requirement is supplemented by a list of specific disclosure objectives.

ASU 2016-02 also requires an extensive list of quantitative disclosures.

The quantitative disclosures required under IFRS are different in many respects, at least in part because the FASB has Type A and Type B leases whereas IFRS has only one lease classification for lessees.

Lessors also are required to disclose both qualitative and quantitative information about leases. Those disclosures include, among other things:

- Information about the nature of its leases, as well as information about significant assumptions and judgments made in applying the lease requirements
- A table of lease income during the reporting period
- Information about how the lessor manages its risk associated with the residual value of its leased asset
- For sales-type/direct financing leases, a maturity analysis of the undiscounted cash flows that comprise the lessor's lease receivables for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter.
- For operating leases, a maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter.

There are a limited number of differences between the FASB's and the IASB's lessor disclosure requirements.

Transition

Both lessees and lessors must apply a modified retrospective transition approach. It is required for all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. No transition accounting is required for leases that expired prior to the date of initial application of the standard.

Both lessees and lessors may elect certain specified reliefs, which must be elected as a package and applied to all leases.

Both lessees and lessors may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases.

Under IFRS, lessees and lessors may use either a full retrospective transition approach or a modified retrospective transition approach. The IASB's modified retrospective transition approach differs from the FASB's approach in some significant ways, however.

For More Information

The AICPA's Financial Reporting Center Leases [webpage](#) contains up-to-date information on the new standard including a video, news articles, member benefit resources and more.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought. Copyright © 2016 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.